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An evaluation of the application of the Cost Accounting Standards: a case study

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AN EVALUATION OF THE APPLICATION OF THE
COST ACCOUNTING STANDARDS:
A CASE STUDY

by

Bruce Neil Lemler

December 1991

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After careful analysis of the three cases, specific conclusions and recommendations are presented. Areas covered include: the Administrative Contracting Officer's (ACO) knowledge of CAS, the ability of smaller companies to adhere to CAS requirements, the Government's policy on cost impact and recovery, the rules regarding the implementation of a new standard, the difficulty in determining the exact cost impact of non-compliance, and problems inherent in the process of resolving non-compliance cases.

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An Evaluation of the Application of the Cost Accounting Standards: A Case Study

by

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of the requirements for the degree of

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ABSTRACT

The purpose of this research project was to examine one company's disagreements with Government contract reviewers over the application of Cost Accounting Standards (CAS). Three specific cases of non-compliance, involving CAS 401, 402, 405 and 418, were examined in detail. These cases were selected because of the relative significance of the dollar amounts involved, the extreme variances in interpreting the standards and methods of implementing the standards, and the inordinate length of time it took to resolve the issues.

After careful analysis of the three cases, specific conclusions and recommendations are presented. Areas covered include: the Administrative Contracting Officer's (ACO) knowledge of CAS, the ability of smaller companies to adhere to CAS requirements, the Government's policy on cost impact and recovery, the rules regarding the implementation of a new standard, the difficulty in determining the exact cost impact of non-compliance, and problems inherent in the process of resolving non-compliance cases.

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I. INTRODUCTION

A. OBJECTIVES OF THE STUDY

The Cost Accounting Standards Board (CASB) was originally established by Congress in order to develop Cost Accounting Standards that would achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal contracts. Once a company falls under the purview of the Standards, it is up to the company to ensure that all of its cost accounting practices meet the requirements imposed by the Standards. For some companies, this can mean a complete restructuring of its cost accounting system, a costly and time consuming process. This, coupled with the fact that the Standards themselves are open to a wide degree of interpretation, have led to many disputes involving the Cost Accounting Standards over the years.

This research project will examine one such company which has had numerous disagreements with Government contract reviewers over the application of Cost Accounting Standards. The company, which for the sake of anonymity will be called American Electronics Corporation (AEC), has been cited for non-compliance with six different Cost Accounting Standards over the past ten years. Three of these cases of non-

compliance (involving four different standards) have been significant in nature and will be the focus of this study. These cases were selected because of the relative significance of the dollar amounts involved, the extreme variances in interpreting the standards and methods of implementing the standards, and the inordinate length of time it took to resolve the issues. In each instance, the company disputes the allegations of non-compliance based on varying interpretations and methods of implementation of the Standards. As a result, the issues have taken years to resolve. This study will evaluate the costing process from both the Government and Industry standpoints in order to develop findings and recommendations from these events for use by others in applying the Cost Accounting Standards.

B. RESEARCH QUESTION

The basic research question for this study is: How did the defense contractor, American Electronics Corporation, and the Government interpret and implement the Cost Accounting Standards, how were the issues resolved, and what conclusions can be drawn by Government and Industry from these events?

The following subsidiary questions were formulated to further define the basic research question:

1. With which Cost Accounting Standards has American Electronics Corporation been in non-compliance, and what are the requirements that these Standards have imposed on Government contractors ?

2. How have these Standards been interpreted by both Government and Industry since their inception ?

3. What are the circumstances surrounding the non-compliance of the Cost Accounting Standards at American Electronics Corporation ?

4. How has American Electronics Corporation attempted to mitigate the non-compliance issues ?

5. What has been the outcome of both the Government´s and the company´s actions to resolve the issues ?

6. What conclusions can be drawn from these cases by both Government and Industry in dealing with the Cost Accounting Standards ?

C. SCOPE, LIMITATIONS, AND ASSUMPTIONS

This thesis will be a case study of American Electronics Corporation´s non-compliance with Cost Accounting Standards 401, 402, 405 and 418. Each of these four Standards will be thoroughly examined in terms of their specific requirements and their application in the case of American Electronics Corporation. Some of the issues involved in this case study go back as far as 1982, and as a result some of the individuals involved, both from the Government and the company, are no longer available to discuss the specific

circumstances surrounding the issues. However, the researcher feels that this limitation is not significant because: (1) documentation from both the Government and the company was thorough and very explicit, and (2) the individuals currently involved with Cost Accounting Standards issues for the Government and the company were familiar with all the issues to be examined in this study and openly discussed the positions that were taken at the time.

Throughout this study it is assumed that the reader is reasonably familiar with basic cost accounting and DOD contracting concepts, procedures and terminology.

D. RESEARCH METHODOLOGY

The information necessary to complete this study was gathered by conducting personal interviews and reviewing available literature, audit reports, memorandums and letters. Interviews were conducted with the current Administrative Contracting Officer (ACO) and the Defense Contract Audit Agency (DCAA) auditor who is currently assigned to conduct audits of the company. During an on-site visit to American Electronics, interviews were conducted with the company's Government Contracts Administrator and the Supervisor, Pricing and Cost Analysis. The interviews were used along with DCAA audit reports, in-house Government memoranda, and letters from

both the ACO and the company to reconstruct the specific circumstances involved in the various Cost Accounting Standard non-compliance issues of American Electronics Corporation. Information on the applicable Cost Accounting Standards was obtained from a thorough review of the Federal Acquisition Regulation (FAR) Part 30, as well as any available literature dealing with the Cost Accounting Standards Board or the Cost Accounting Standards.

In soliciting their cooperation for this project, individuals representing both the Government and the company have been given complete anonymity. Also, the company has been disguised (name, industry, location) in order to preserve its confidentiality. As a result of this, the letters, memoranda and audit reports that were obtained from these sources and used in this research can not be referenced. Excerpts from these documents will be used to provide the reader with a better understanding of the issues, and will be identified as such in the text.

The literature utilized in this study was compiled from multiple sources, including the Defense Logistics Information Exchange (DLSIE), the Defense Technical Information Center (DTIC), the Federal Legal Information Through Electronics (FLITE), previous theses, and a review of current publications and periodicals relevant to the fields of Federal procurement

and accounting.

E. ORGANIZATION OF THE STUDY

Chapter II will present a brief history of how and why the Cost Accounting Standards Board was established, and a discussion of the authority granted to the Board. Also, the requirements of each of the Cost Accounting Standards to be analyzed in the three cases will be discussed in detail as well as any significant interpretations made by Government or Industry of those Standards since their inception.

Chapters III, IV and V each cover a Cost Accounting Standard non-compliance case involving American Electronics Corporation. Each chapter contains a complete discussion of the facts involved, resolution of the issues and analysis of the actions taken and decisions made by each party. Chapter III will contain background information on American Electronics Corporation and will cover CAS 401 and CAS 402. Chapter IV will cover CAS 405, and Chapter V will cover CAS 418.

Chapter VI will present the conclusions and recommendations that follow from analysis of the cases.

F. FUTURE IMPLICATIONS

Recently, the CASB was reestablished after an absence of ten years. The disestablishment of the Board in 1980 left no method of responding to the many cost accounting problems and issues arising out of the ever-changing business of Department of Defense procurement. All of the original standards remained in the Government contracting law, but there was no one with authority to make needed revisions or issue new standards as circumstances would dictate. This situation has led to the formation of a new CASB. [Ref. 1: p. 56]

The new CASB will be examining the existing standards for problem areas and making revisions where appropriate. They will also be looking at a myriad of new issues that have developed over the past ten years, including: cost impact proposals, special business units, allocation of state income and franchise tax, material costs, allocation of G&A cost, mergers and acquisitions, pensions, computer software costs, technological modernization, and allocation of special facilities. It is expected that these and other issues will be the subject of pronouncements by the new CASB. [Ref. 1: p. 56-59]

II. FRAMEWORK AND BACKGROUND

A. INTRODUCTION

This chapter will establish the conceptual framework for the role of the Cost Accounting Standards in the Government procurement process. The chapter begins with a historical look at the establishment of the Cost Accounting Standards Board (CASB) and the authority that was empowered to the Board. Then, the four Cost Accounting Standards which are the focus of this study will be discussed in detail, including the specific requirements imposed by each of the Standards and any significant interpretations that have been made by the Government or Industry since the inception of these Standards.

B. ESTABLISHMENT OF THE COST ACCOUNTING STANDARDS BOARD (CASB)

Prior to the establishment of the Cost Accounting Standards Board (CASB), Section XV of the Armed Services Procurement Regulations (ASPR) was the only guide available for evaluating the cost accounting practices of Government contractors. In an attempt to provide regulatory guidance, the ASPR relied heavily on generally accepted accounting principles, which pertain more to financial accounting

procedures than to product costing, and IRS rules which have limited applicability to Government contracting. With these regulations, it was very possible for firms doing business with the United States Government using cost reimbursement contracting to support reimbursement of costs beyond what they actually incurred in their contract work.

There is no question that industry was opposed to the imposition of uniform cost accounting standards. In a 1986 study, it was shown that during the period just prior to the establishment of the CASB when there was serious debate aimed at establishing the necessity and feasibility of uniform cost accounting standards, there was an average cumulative shareholder wealth loss of 2.84% in the defense industry. These losses were driven mainly by decreases in shareholder wealth to contractors who were in a less competitive environment. The study indicates that, at least for the less competitive contractors, the real possibility of regulated cost accounting practices would mean decreased profits because of the firm's inability to extract excessive cost reimbursements from the Government. [Ref. 2: p. 314]

With increasing technologically advanced systems being procured and more highly diversified conglomerates dominating the defense industry, Government officials were becoming more and more convinced of the need to closely monitor contractor's

costs. The only way to do this successfully would be through a set of uniform cost accounting standards that could be consistently applied throughout the multi-faceted defense industry.

The birth of the CASB can be attributed in large measure to Admiral Hyman Rickover, who was a strong advocate for a system of uniform cost accounting standards. In 1968, during congressional hearings on the extension of the Defense Production Act of 1950, Admiral Rickover argued that the lack of uniform cost accounting standards offered the defense industry an opportunity to increase profits on defense contracts. Without uniform standards, the Government could not measure the actual costs of contracts and defense contractors were able to claim reimbursement for costs not incidental to the contracts. He further stated that the use of uniform cost accounting practices would save taxpayers $2 billion per year. [Ref. 2: p. 296]

The position taken by Rickover and other proponents for congressional action was opposed unanimously by both the private and public sectors. The American Institute of Certified Public Accountants (AICPA), industry associations and individual Government contractors, the Department of Defense and the General Accounting Office either strongly opposed such legislation or asserted the concept was vague and

argued that it was neither feasible or desirable to impose a standard accounting system for the myriad of defense contractors. [Ref. 3: p. 206]

Even under this strong opposition, the congressional CAS proponents succeeded in enacting a measure which called for a study to determine the feasibility of applying uniform cost accounting standards to negotiated prime and subcontracts in excess of $100,000. The study was conducted by the Comptroller General, in cooperation with the Secretary of Defense and the Director of the Bureau of the Budget and included consultation with the accounting profession and the defense industry.

In January 1970, the Comptroller General submitted a report on the feasibility study to Congress. The report concluded that it was both feasible and desirable to establish and apply cost accounting standards to provide a greater degree of uniformity and consistency in cost accounting than presently existed. It further recommended that a new mechanism be established for the development of cost accounting standards. However, one caveat that the report did include concerned the limitations of these standards. The report stated that while establishing standards is feasible and desirable, it is not feasible to establish and apply cost accounting standards in such detail as would be necessary to

ensure a uniform application of precisely prescribed methods of computing costs for each of the different kinds of costs, under all the wide variety of circumstances involved in Government contracting. [Ref. 3: p. 207] From this, it is evident that the result intended from the study would be the development of a set of standards or guidelines that would be very general in nature so that they could be easily implemented by industry and enforced by the Government without a massive upheaval of established cost accounting systems and the ensuing costs that would be involved.

In March 1970, congressional hearings on legislation to implement the recommendations from the report began. The hearings in both houses attracted many witnesses with strong feelings on the issue. In the end, it was determined that a definite need for cost accounting standards did exist. On August 15, 1970, President Richard Nixon signed Public Law 91-379, an amendment to the Defense Production Act of 1950, which established the Cost Accounting Standards Board (CASB).

The most significant provisions of the statute as it relates to Government contracting are summarized below. [Ref. 3: p. 208-209]

1. It established the CASB as an agent of Congress consisting of the Comptroller General, serving as chairman of the Board, and four members to be appointed by the Comptroller General. Of these, two must be from the accounting profession (one of which must be particularly

knowledgeable about the cost accounting problems of small business), and one each from industry and a federal agency.

2. It gave the Board authority to promulgate cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal contracts. Once promulgated, the standards must be used by all relevant Federal agencies and by defense contractors and subcontractors in estimating, accumulating, and reporting costs in connection with pricing, administration and settlement of all negotiated prime contract and subcontract national defense procurements with the U.S. in excess of $100,000. The only exceptions being where the price negotiated is based on; (1) established catalog or market prices of commercial items sold in substantial quantities to the general public, or (2) prices set by law or regulation.

3. It required that the CASB in promulgating a standard must report to the Congress the probable costs of implementation compared to the probable benefits, including advantages and improvements in the pricing, administration, and settlement of contracts.

4. It required defense contractors and subcontractors to disclose in writing their cost accounting principles (Disclosure Statement) and to agree to a contract price adjustment for any increased costs paid to the contractor because of non-compliance with the standards or failure to consistently follow their disclosed cost accounting principles. Disputes would be handled under the contract dispute clause.

5. In order to enforce implementation and adherence, it gave any authorized representative of the head of the agency concerned, of the Board, or of the Comptroller General, the authority to examine and make copies of any documents, papers, or records of the contractor or subcontractor relating to compliance with the standards and disclosed cost accounting principles.

In late 1970, Congress passed the necessary bill to implement the Statute and it was signed into law early in January, 1971. The first CASB meeting was held on February 9,

1971. The following month, the Board's first executive secretary was named and he assumed duties on April 1, 1971. Thereafter, recruitment of the other staff members began, as did planning and research for the promulgation of standards and regulations to meet the requirements established by law. [Ref. 3: p. 210]

C. THE ROLE OF OTHER GOVERNMENT ORGANIZATIONS

Different Government organizations have varying roles with regard to implementation, interpretation and audit of the Cost Accounting Standards. Since the CASB was dissolved in 1980, these functions have been left largely to the Defense Contract Management Command (DCMC), the Defense Contract Audit Agency (DCAA), the Armed Services Board of Contract Appeals (ASBCA), the Federal Courts, and the General Accounting Office (GAO).

DCMC is the principal Government organization for contract administration. Within the DCMC field offices, Administrative Contracting Officers (ACO) are assigned responsibility for administration of Government contracts. This includes the responsibility of ensuring that Government contractors and subcontractors are in compliance with all the requirements of the Cost Accounting Standards. When conflicts arise involving the Standards, the ACO must make decisions relative to the contractor's compliance, evaluate the cost impact of non-

compliance, and negotiate an equitable adjustment of the contract price.

DCAA was established for the purpose of performing all necessary contract auditing for the Department of Defense and providing accounting and financial advisory services in connection with the negotiation, administration, and settlement of contracts and subcontracts. The DCAA auditor does not possess any decision making authority, but rather conducts audits and reports findings and recommendations to the ACO for action. In regard to the Cost Accounting Standards, the cognizant contract auditor is responsible for making recommendations to the ACO as to whether: [Ref. 4: p. 805]

a. A contractor's Disclosure Statement, submitted as a condition of contracting, adequately describes the actual or proposed cost accounting practices.

b. A contractor's disclosed cost accounting practices are in compliance with FAR Part 31 and applicable Cost Accounting Standards.

c. A contractor's or subcontractor's failure to comply with applicable Cost Accounting Standards or to follow consistently its disclosed cost accounting practices has resulted, or may result, in any increased cost paid by the Government.

d. A contractor's or subcontractor's proposed price changes, submitted as a result of changes made to previously disclosed or established cost accounting practices, are fair and reasonable.

The ASBCA, Federal Courts and GAO are all involved in the interpretation of the Standards through adjudication of disputes and protests. When the ACO and the contractor are unable to negotiate and settle differences, litigation is initiated by issuance of a contracting officer´s "final decision" and appeal of that decision by the contractor. The Contract Disputes Act of 1978 provided that agency heads appoint boards of contract appeals to decide issues. If the contractor does not agree with the decision of the ASBCA, they have the right to appeal up to the Federal Courts. [Ref. 5: p. 63]

The GAO has primary responsibility for reviewing bid protest and award protest cases. These cases typically involve the method of conducting the source selection evaluation, qualification of the low bidder, or the responsiveness of the bidder who was awarded the contract. Issues relative to the Cost Accounting Standards could be raised during the review. If the contractor does not agree with the decision of the GAO they have the right to appeal up to the Federal Courts.

D. COST ACCOUNTING STANDARD (CAS) 401

CAS 401, Consistency in Estimating, Accumulating and Reporting Costs, became effective on July 1, 1972. It is fundamentally the most basic of all the standards in attempting to achieve uniformity and consistency in cost accounting practices. The purpose of CAS 401 as stated by the CASB is: [Ref. 6: Subpart 30.401-20]

> . . . to ensure that each contractor's practices used in estimating costs for a proposal are consistent with cost accounting practices used by him in accumulating and reporting costs. Consistency in the application of cost accounting practices is necessary to enhance the likelihood that comparable transactions are treated alike. With respect to individual contracts, the consistent application of cost accounting practices will facilitate the preparation of reliable cost estimates used in pricing a proposal and their comparison with the costs of performance of the resulting contract. Such comparisons provide one important basis for financial control over costs during contract performance and aid in establishing accountability for costs in the manner agreed to by both parties at the time of contracting. The comparisons also provide an improved basis for evaluating estimating capabilities.

The purpose of CAS 401 as stated above gets to the very heart of why the CASB was established. It provides a means of measuring the costs on contracts in a more consistent manner in order to facilitate financial control over contractors. This is the very thing that Admiral Rickover was seeking during his address to Congress. CAS 401 was designed to facilitate reliable cost estimates that could easily be

compared with actual cost data in order to enhance financial control over costs, accountability for cost overruns and a basis for evaluating a contractor's cost estimating system.

To implement CAS 401, the CASB promulgated three fundamental requirements: [Ref. 6: Subpart 30.401-40]

a. A contractor's practices used in estimating costs in pricing a proposal shall be consistent with his cost accounting practices used in accumulating and reporting costs.

b. A contractor's cost accounting practices used in accumulating and reporting actual costs for a contract shall be consistent with his practices used in estimating costs in pricing the related proposal.

c. The grouping of homogeneous costs in estimates prepared for proposal purposes shall not per se be deemed an inconsistent application of cost accounting practices under paragraphs a and b when such costs are accumulated and reported in greater detail on an actual cost basis during contract performance.

In the Techniques For Application section of the Standard, the CASB describes in greater detail what it meant by the word <u>consistent</u>. The three main points in the consistent application of costs are: [Ref. 6: Subpart 30.401-50]

1. The classification of costs as <u>direct or indirect</u>.

2. The <u>indirect cost pools</u> to which each element or function of cost is charged or proposed to be charged.

3. The <u>methods of allocating</u> indirect costs to the contract.

E. INTERPRETATIONS OF CAS 401

1. Data-Design Laboratories, ASBCA No. 27245, 86-2 BCA par. 18,830.

In this case the dispute did not result from a contracting officer's final determination of non-compliance with CAS 401. But rather, one of the main issues that this case focused on was whether a retroactive cost disallowance imposed by a contracting officer could be upheld by the ASBCA in view of the requirements of CAS 401.

Data-Design Laboratories (DDL) was made up of three divisions, Technical Services, Instruments and Hydrotronics. The three divisions had one combined G&A expense pool, however, Technical Services and Instruments had one combined overhead cost pool while Hydrotronics had its own. The Instruments Division was mainly involved in manufacturing operations, while the Technical Services Division was mainly involved in engineering technical services. In the early 1970's about 40% of the sales of the Technical Services Division involved manufacturing, but in the FY 1978-80 period it dropped to a much lower level, as low as 3%. The Instruments Division contracts were all fixed price, whereas the Technical Services Division contracts were almost all cost plus fixed fee. Before 1976, the Government voiced no objection to DDL's use of a single overhead pool for these two

divisions. Significant changes occurred in the volume of sales and production of DDL's Instruments Division from FY 1975 to FY 1976 and subsequent years. For example, sales changed from $365,000 in FY 1975 to $1,334,000 in FY 1976.

The Government considered that because of the increase in sales and production of the Instruments Division, this combined overhead pool no longer allocated overhead costs accurately. This pool was allocated on the basis of direct labor dollars, and engineers were being paid substantially more than manufacturing personnel. Manufacturing overhead costs were considered to be improperly shifted from manufacturing operations to engineering operations.

After discussions with the contractor, a written agreement was entered into between the Government and DDL whereby DDL agreed to establish a separate overhead pool for each division. DDL submitted a formal accounting practice change setting up the separate overhead pools, which was in accordance with the written agreement and which was approved by the Government. At the same time DDL also submitted a formal accounting practice change from a total cost input (sum of material labor and factory overhead costs) to a value added base (e.g. direct labor) for the allocation of G&A. This request was disapproved by the Government. DDL then withdrew both accounting practice change requests and after having

followed the two pool method for about two months changed back to their old system. While it was not stipulated in the written agreement, DDL had thought from prior discussions that the Government would allow an offsetting change in the way DDL accounted for G&A expense.

The two issues that the ASBCA examined in deciding this case were, the applicability of the written agreement, and the requirements of CAS 401. Specifically, whether CAS 401 by its very nature precludes a contracting officer from imposing a retroactive cost disallowance where a retroactive change in the accounting practice of a contractor would lead to an inconsistency between estimating and accumulating of costs.

In making their decision the ASBCA looked to a letter that had been sent by the CASB to DOD in November 1973 which addressed this very issue. Shortly after CAS 401 became effective, DOD was concerned that it would preclude a retroactive change in a contractor´s accounting practice even when a contractor´s previously established and/or disclosed accounting practice is subsequently considered to yield inequitable results under one or more CAS covered contracts.

The CASB´s formal advice to DOD was twofold. First, changes in established cost accounting practices during contract performance may be made when authorized by standards,

rules, and regulations issued by the CASB and that modifications of established cost accounting practices for accumulating and reporting costs are permitted by other regulations of the CASB without causing a violation of CAS 401. The letter referred specifically to the Cost Accounting Standards Contract clause, paragraph (a)(4)(B), which states that a change to cost accounting practices during performance of a contract may be proposed by either the Government or the contractor. The second and somewhat contradictory bit of advice that the CASB put in the letter was: [Ref. 7: p. 94,884-94,885]

> A consequence of the CASB standards, rules, and regulations may be to make it more difficult for the party advocating change to persuade a board or court to support its position. We believe that this might be the case primarily because consistency in cost accounting practices has been explicitly identified as a characteristic generally meriting protection. This identification can be found not only in the standards issued by the Board but also in the underlying language of its legislation. Paragraph (g) of Public Law 91-379 (establishing the CASB) requires the Board to promulgate Cost Accounting Standards designed to achieve uniformity and consistency. In prescribing this requirement, we believe that the Congress recognized that in the long run the value of consistency would more than compensate for any transitory advantages which might be lost as a result of inhibitions imposed on changing cost accounting practices to accommodate temporary conditions.

From this, DOD concluded that a retroactive disallowance under certain circumstances was not contrary to CAS 401. The ASBCA decided that this case did not present the

appropriate circumstances for a retroactive disallowance and found that DDL was entitled to reasonably adequate notice that the Government would no longer approve the use of their accounting practice.

The ASBCA´s interpretation of the applicability of CAS 401 seems to be consistent with that of the CASB. The CASB recognized that CAS 401 may put some limitations on the Government´s absolute authority to retroactively disallow a contractor´s accounting practice when it felt justified. However, any limitations that might be imposed were worthwhile because of the greater importance to maintain consistency in estimating, accumulating and reporting costs. The CASB recognized that each case would have to be weighed on its own merits to see if the imposition of a retroactive change was justified and would provide a greater good than maintaining consistency. In this case, the ASBCA decided that maintaining consistency and fairness was of greatest importance.

2. Dayton T. Brown, ASBCA No. 22810, 78-2 BCA par.13,484; 80-2 BCA par.14,543.

This case involves a contracting officer´s final determination of non-compliance with CAS 401 regarding the contractor´s method of accounting for bid and proposal (B&P) costs. The contractor appealed the decision to the ASBCA who found for the contractor, then after rehearing the case under

the Government´s motion for reconsideration ruled against the contractor.

Brown was a small company consisting of a corporate office and three divisions; Manufacturing, Laboratory and Technical. Manufacturing had virtually no Government contracts while the other two were heavily defense-oriented. Prior to 1975, Brown collected its B&P costs in its corporate headquarters G&A pool and then reallocated these costs back to the divisions on a total cost input basis. The result being a disproportionate allocation of B&P to the commercial Manufacturing Division because it incurred little B&P work but had the largest cost input base. The Government had no objection to this practice. [Ref. 8: p. 65,977]

In 1975, Brown´s commercial business began to fall off and the company increased its B&P efforts in the Manufacturing Division significantly. This resulted in an increase in total company B&P costs which then required Brown to use the ASPR formula for determining the allowability of B&P costs. In computing B&P costs for 1975 using the formula, Brown changed its procedure by applying the formula after the B&P costs had been allocated to the divisions. DCAA recomputed allowable B&P costs by applying the formula at the corporate level and arrived at a substantial amount of B&P costs questioned. The major portion of the amount disallowed represented a lesser

allocation of these costs to the defense-oriented divisions. [Ref. 9: p. 71,687]

In arriving at its initial decision for Brown, the ASBCA only concerned itself with the propriety, under the ASPR provisions, of Brown´s computing its allowable 1975 B&P costs by applying the formula to its divisional level. As such, it concluded that Brown had not violated the requirements of CAS 401. It reasoned that CAS 401 requires consistency between accumulating and reporting costs, on the one hand, and estimating costs on the other, not between accumulating costs and reporting costs as in this case. Also, since Brown did not use the formula for estimating in 1975, it would be an impossibility for there to be an inconsistency between its application of the formula in reporting its costs in 1975 and in estimating costs for that year.

The ASBCA agreed to rehear the case under the Government´s motion for reconsideration. The Government was able to clarify its position, and asked the Board to consider whether Brown´s reporting of its incurred B&P costs at the division level constitutes an inconsistency prohibited by CAS 401 in view of its accounting practice to estimate these costs by using indirectly allocated costs at the corporate level. The Board reversed its initial decision by concluding that Brown had violated CAS 401. The Board ruled that the

inconsistency prohibited by CAS 401 arose from Brown's reporting its allowable B&P costs based on incurred divisional costs, which was inconsistent with its established accounting practice of estimating B&P costs on the basis of their allocation from the corporate G&A expense pool. [Ref. 9: p. 71,691]

This case presents a classic example of the type of situation where CAS 401 is designed to be applied. If a contractor were allowed to estimate costs using one method, and accumulate and report costs using another, then it would be impossible to hold the contractor accountable for costs. The contractor would have free reign to estimate low, in order to win the award, and then allocate costs as high as possible, in order to increase his profit margin. The difference in Brown's methods of estimating and accumulating is subtle but nevertheless can be used quite conveniently to manipulate costs. There is no question that both the Government and the ASBCA were correct in their interpretation of CAS 401 in this case.

3. **Texas Instruments, Inc., ASBCA No. 18621, 79-1 BCA par.13,800; 79-2 BCA par.14,184.**

This case is based on a contracting officer's final determination of non-compliance with CAS 401. The Government's position was that Texas Instruments' (TI) cost

accounting practices in not accumulating and reporting costs by individual contracts, are inconsistent with its estimating practices which, in the Government´s opinion, are based on a single contract. The ASBCA did not agree and ruled in favor of TI.

The controversy surrounds TI´s cost accounting system. For fixed-price supply contracts, TI does not accumulate costs by individual contract but instead the cost accounting system is based on accumulating costs by projects. Projects relate costs to identical or similar products, based on commonalities of subassemblies, parts, etc., regardless of the origin for the order of the products. The system is designed to allow TI to buy large quantities of material at lower costs instead of making buys on an as needed basis for individual contracts. [Ref. 10: p. 67,607]

The Government contends that since TI uses DD Form 633 (used to develop the cost estimate for a proposal) to estimate costs for an individual contract, then the accumulation and reporting of costs must also be on a single contract basis in order to comply with CAS 401. TI argued that its estimating practices were consistent with its cost accounting practices in accumulating and reporting costs since both produced average costs of a unit or a part as necessary. TI contends

that DD Form 633 in itself is not indicative of its estimating practices.

The Board did not agree with the Government´s contentions and found that since the costs on the DD Form 633 were based on historical cost data derived from the various projects and represented the average costs of many units manufactured under many contracts, they did not represent the costs incurred under a single contract. Further, the Board concluded that CAS 401 does not require accumulation, reporting, and estimating of costs by individual contracts. To the contrary, the Board found evidence that the CASB intentionally left out any language that referred to "individual contracts" when the final draft of CAS 401 was submitted. [Ref. 10: p. 67,618-67,621]

The Government´s interpretation of CAS 401 in this case was way off base. The CASB never intended such a strict interpretation as evidenced by the careful exclusion of any references to "individual contracts" in CAS 401. To follow that fine an interpretation would go against the findings of the feasibility study which called for standards to be developed but guarded against defining too finely the exact practices to be used by contractors. This would cause an unnecessary upheaval in contractors´ cost accounting systems.

Consistency can be achieved without imposing massive costs on industry.

In this case, TI was being consistent in their practice of estimating, accumulating and reporting costs and the fact that they were using the DD Form 633, as required, to submit a cost proposal is inconsequential to their consistent application of costs.

F. COST ACCOUNTING STANDARD (CAS) 402

CAS 402, CONSISTENCY IN ALLOCATING COSTS INCURRED FOR THE SAME PURPOSE, was issued at the same time as CAS 401 and has an effective date of July 1, 1972. The purpose of CAS 402 as stated by the CASB is: [Ref. 6: Subpart 30.402-20]

> . . . to require that each type of cost is allocated only once and on only one basis to any contract or other cost objective. The criteria for determining the allocation of costs to a product, contract, or other cost objective should be the same for all similar objectives. Adherence to these cost accounting concepts is necessary to guard against the overcharging of some cost objectives and to prevent double counting. Double counting occurs most commonly when cost items are allocated directly to a cost objective without eliminating like cost items from indirect cost pools which are allocated to that cost objective.

Similar to CAS 401, CAS 402 is attempting to legislate consistency in the way costs are allocated to contracts in order to facilitate the auditing process and prevent the gross overstatement of costs. Basically, the CASB felt it was

necessary to tell industry something that should have been intuitively obvious, that is to treat like costs alike and don´t charge a cost off to a contract more than once.

The fundamental requirement imposed on contractors by CAS 402 is: [Ref. 6: Subpart 30.402-40]

> All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective. Further, no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any direct cost pool to be allocated to that or any other final cost objective.

The "Techniques for Application" section of the Standard further defines exactly what is required of contractor´s to be in compliance with CAS 402. The five main points that this section brings out are: [Ref. 6: Subpart 30.402-50]

a. CAS 402 is not only applicable to actual costs incurred but is also equally applicable to estimates of costs to be incurred as used in contract proposals.

b. The contractor will specify in the Disclosure Statement his cost accounting practices with regard to the distinction between direct and indirect costs. Also, for those types of costs which are sometimes accounted for as direct and sometimes accounted for as indirect, the contractor will set forth in his Disclosure Statement the specific criteria and circumstances for making such distinctions. Thus, the Disclosure Statement is very important as it becomes the main vehicle used to determine whether or not costs are incurred for the same purpose.

c. If the contractor has not submitted a Disclosure Statement, the determination of whether specific costs are directly allocable to contracts shall be based on the contractor's cost accounting practices used at the time of contract proposal.

d. Whenever costs which serve the same purpose cannot equitably be indirectly allocated to one or more final cost objectives in accordance with the contractor's disclosed accounting practices, the contractor may either (a) use a method for reassigning all such costs which would provide an equitable distribution to all final cost objectives, or (b) directly assign all such costs to final cost objectives with which they are specifically identified. In the event the contractor decides to make a change for either purpose, the Disclosure Statement shall be amended to reflect the revised accounting practices involved.

e. A direct cost of minor dollar amount may be treated as an indirect cost for reasons of practicality where the accounting treatment for the cost is consistently applied to all final cost objectives, provided that such treatment produces results which are substantially the same as the results which would have been obtained if the cost had been treated as a direct cost.

The key words in applying CAS 402 are, "costs incurred for the same purpose in like circumstances." Because although a cost may be incurred for the same general purpose and charged indirectly, a portion of that cost may be incurred for some more specific purpose which would permit that portion of the cost to be charged directly to the applicable final cost objective. The bottom line for auditors is that a thorough examination of the facts must be conducted before a contractor can be assumed to be in non-compliance. [Ref. 4: p. 827]

G. INTERPRETATIONS OF CAS 402

1. Cost Accounting Standards Board Interpretation No. 1

One of the significant problems that surfaced with the publication of CAS 402 was the application of the Standard to bid and proposal (B&P) costs. Contractors were using a wide variety of methods to account for B&P costs and so the CASB felt it was necessary to officially take a position on the accounting treatment of these costs. On June 18, 1976, Interpretation No. 1 to CAS 402 was published in its final form in the Federal Register and stated in part that: [Ref. 6: Subpart 30.402-61]

> . . . costs incurred in preparing, submitting, and supporting proposals pursuant to a specific requirement of an existing contract are considered to have been incurred in different circumstances from the circumstances under which costs are incurred in preparing proposals which do not result from such specific requirement. The circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor.

What the CASB is essentially saying is that B&P costs may be charged directly when they are incurred pursuant to the specific requirement of an existing contract, such as proposal costs incurred in connection with the definitization of letter contracts, orders issued under basic ordering agreements or modifications to an existing contract. Other B&P costs which

relate to all work of the contractor must be charged indirectly.

This interpretation reinforces the idea that when applying CAS 402 it is important to remember that even though costs may be alike, they can be accounted for differently if some costs are incurred for a specific purpose and can be traced directly to a final cost objective.

2. **Comptroller General´s Decision No. B-216516, November 19, 1984.**

This Comptroller General´s decision was made pursuant to a bid protest by CACI, Inc., contending that the Government´s evaluation of its proposal was in violation of CAS 402. In evaluating the bids for a certain contract, the Government lowered the cost proposal of the highest bidder and increased the cost proposal of CACI, which had submitted the lowest proposal. The Government felt that the accounting function for this contract required the assignment of dedicated personnel and that these costs should be charged direct. Because of the changes the Government made in the cost proposals, CACI was no longer low bidder and did not get the award. CACI protested the award asserting that they had historically accounted for accounting costs as indirect costs and to change that practice for this contract would be in violation of CAS 402. [Ref. 3: p. 261]

The Government argued that because dedicated accounting personnel are necessary and can be identifiable with a particular final cost objective, the cost must be charged as a direct cost to the contract. However, the GAO did not agree. In its decision, the GAO pointed out that if CACI charged the accounting function as indirect under other contracts, it must be consistent under this contract. The decision also pointed out that if this contract required something different from CACI´s ordinary accounting functions, then it is possible that CACI could elect to charge this as a direct cost. However, even in this event it would be CACI´s initial election of how it wanted to manage its accounting system, so long as CACI complied with CAS. GAO found that the Government improperly added the accounting function as a direct charge and thus was not following the provisions of CAS 402. [Ref. 3: p. 262]

The decision made by the GAO was significant because it prevented the Government from taking an action that was contrary to the Cost Accounting Standards. In relation to CAS 402 it reinforced the CASB´s intention to promote consistency in allocating costs, even if that meant disallowing certain actions on the part of the Government.

H. COST ACCOUNTING STANDARD (CAS) 405

CAS 405, ACCOUNTING FOR UNALLOWABLE COSTS, became effective on January 1, 1974. The purpose of CAS 405 as stated by the CASB is: [Ref. 6: Subpart 30.405-20]

> . . . to facilitate the negotiation, audit, administration and settlement of contracts by establishing guidelines covering (1) identification of costs specifically described as unallowable, at the time such costs first become defined or authoritatively designated as unallowable, and (2) the cost accounting treatment to be accorded such identified unallowable costs in order to promote the consistent application of sound cost accounting principles covering all incurred costs.

CAS 405 is not concerned with the designation of costs or certain classes of costs as unallowable, that function is left to the appropriate procurement or reviewing authority and is covered quite thoroughly in FAR Part 31. Instead, CAS 405 is concerned with the identification of these costs by the contractor and the accounting treatment afforded these costs. The CASB felt that the failure of contractors to identify unallowable costs, the lack of uniformity or comparability in the cost accounting treatment accorded unallowable costs and the reported problems concerning the content of indirect-cost allocation bases where unallowable costs are involved, were sufficient justification for establishing CAS 405 [Ref. 6: Part 30, App. A, p. I-17].

The requirements imposed on contractors by CAS 405 as contained in the Standard are: [Ref. 6: Subpart 30.405-40]

a. Costs expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract.

b. Costs which specifically become designated as unallowable as a result of a written decision furnished by a contracting officer pursuant to contract disputes procedures shall be identified if included in or used in the computation of any billing, claim, or proposal applicable to a Government contract. This identification requirement applies also to any costs incurred for the same purpose under like circumstances as the costs specifically identified as unallowable under either this paragraph or paragraph (a).

c. Costs which, in a contracting officer´s written decision furnished pursuant to contract disputes procedures, are designated as unallowable directly associated costs of unallowable costs covered by either paragraph (a) or (b) shall be accorded the identification required by paragraph (b).

d. The costs of any work project not contractually authorized, whether or not related to performance of a proposed or existing contract, shall be accounted for, to the extent appropriate, in a manner which permits ready separation from the costs of authorized work projects.

e. All unallowable costs covered by paragraphs (a) through (d) shall be subject to the same cost accounting principles governing cost allocability as allowable costs. In circumstances where these unallowable costs normally would be part of a regular indirect-cost allocation base or bases, they shall remain in such base or bases. Where a directly associated cost is part of a category of costs normally included in an indirect-cost pool that will be allocated over a base containing the unallowable cost with which it is associated, such a directly associated cost shall be retained in the indirect-cost pool and be allocated through the regular allocation process.

f. Where the total of the allocable and otherwise allowable costs exceeds a limitation-of-cost or ceiling-price provision in a contract, full direct and indirect cost allocation shall be made to the contract cost objective, in accordance with established cost accounting practices and Standards which regularly govern a given entity's allocations to Government contract cost objectives. In any determination of unallowable cost overrun, the amount thereof shall be identified in terms of the excess of allowable costs over the ceiling amount, rather than through specific identification of particular cost items or cost elements.

Industry was outspokenly opposed to much of the language contained in CAS 405, but by far the most criticism was addressed to the requirement that unallowable costs shall be subject to the same cost accounting requirements as allowable costs in determining the content of cost-oriented bases for allocation of indirect costs. However, the CASB in replying to the criticism indicated that the issues concerning cost allocation and those relating to cost allowance are distinct and separate. Further, allowability should not be a factor in the selection or in the determination of the content of an allocation base used to distribute a pool of indirect costs, and the appropriateness of a particular allocation base should be determined primarily in terms of its distributive characteristics. The CASB felt that any selective fragmentation of an allocation base which eliminates given base elements for only some of the relevant cost objectives

would produce a distortion in the resulting allocations. [Ref. 6: Part 30, App. A, p. I-19]

As was its standard practice, the CASB carefully reviewed all criticism of a proposed Standard and made changes as it felt were appropriate. In the case of CAS 405, few changes were made because the CASB believed that the application of CAS 405 would provide a greater degree of uniformity in the determination of costs of negotiated defense contracts.

I. INTERPRETATIONS OF CAS 405

1. Emerson Electric Company, ASBCA No.30090, 87-1 BCA par. 19478.

This case concerns the Emerson Electric Company´s appeal of a contracting officer´s final decision of non-compliance with CAS 405. The circumstances of the case relate to the specificity that a regulation must contain in order for a cost to be considered "expressly unallowable" according to CAS 405.

The non-compliance issue involves the inclusion of foreign selling costs in the G&A expense pool and thus the eventual allocation of these alleged unallowable costs to Government contracts. During the period from 1 October 1979 to 3 August 1983, Emerson calculated its G&A expense rate for DOD domestic contracts on a single pool basis. In computing

this rate, all G&A expenses incurred by Emerson, including all selling costs, were collected in a single pool which after excluding any expressly unallowable costs was divided by the total costs incurred by Emerson during the fiscal year. Under this method, foreign military products selling costs were not excluded from Emerson´s single G&A pool. [Ref. 11: p. 98,415]

The ACO determined that foreign military products selling costs were unallowable costs for U.S. Government contracts based on the provisions of the Defense Acquisition Regulation, 15-205.37(b) (the pertinent regulation prior to the Federal Acquisition Regulation and the Defense Supplement to the FAR), which states that selling costs are allowable to the extent they are reasonable and are allocable to Government business, and that selling costs incurred in connection with potential and actual foreign sales of military products shall not be allocable to U.S. Government contracts. Emerson contends that this regulation does not expressly state that foreign selling costs are unallowable and thus are not subject to the accounting requirements of CAS 405. In deciding the case the ASBCA must attempt to interpret what the CASB meant by "expressly unallowable" and relate that to the DAR provision in order to determine the applicability of CAS 405.

In order to try and interpret what the CASB meant by "expressly unallowable," the ASBCA looked at the published

preambles which accompany each Cost Accounting Standard and serve as the official legislative history of the Standard. In the preamble to CAS 405, explaining the intended meaning of the phrase "expressly unallowable," the CASB stated: [Ref. 6: Part 30, App. A, p. I-18]

> Most of the items of cost that are of the type required to be accounted for as expressly unallowable are specified in agency procurement regulations. It would not be practical to list the items of cost that may be made expressly unallowable under the specific provisions of contracts. The Board, in its definition of an "expressly unallowable cost," has used the word "expressly" in the broad dictionary sense - that which is in direct or unmistakable terms.

The ASBCA then applied this to the DAR provision and found that while the DAR provision could have been more direct if the words "unallowable" or "not recoverable" had been used, nevertheless the meaning imparted by the DAR provision was unmistakable. Taken as a whole, the ASBCA found that the DAR provision clearly makes foreign military products selling costs "expressly unallowable" under domestic Government contracts, and thus Emerson was in non-compliance with CAS 405.

This case can certainly be held up as an example to contractor´s who may try to evade the requirements of CAS 405 through twists in the wording of the Standard and applicable agency regulations. The ACO and the ASBCA recognized that the

provisions of a Government regulation making a cost unallowable cannot be voided through literal interpretations of the wording. Rather, one must interpret the meaning and apply some deductive reasoning to come up with a logical conclusion concerning the allowability of costs and compliance with CAS 405.

J. COST ACCOUNTING STANDARD (CAS) 418

CAS 418, ALLOCATION OF DIRECT AND INDIRECT COSTS, was over two years in the making before it was finally promulgated, and took up most of the CASB's time during its final few years of existence. CAS 418 started out as five separate standards, was subsequently pared down to three separate standards after the CASB received much criticism of the five standards, and was finally neatly packaged into one standard (again due to significant criticism of the three standards) which became effective on September 20, 1980. The purpose of CAS 418 as stated by the CASB is: [Ref. 6: Subpart 30.418-20]

> (a) to provide for consistent determination of direct and indirect costs, (b) to provide criteria for the accumulation of indirect costs, including service center and overhead costs, in indirect cost pools, and (c) to provide guidance relating to the selection of allocation measures based on the beneficial or causal relationship between an indirect cost pool and cost objectives.

CAS 418 is concerned with the consistent classification of costs as direct and indirect, and the proper allocation of indirect costs to cost objectives. In order to achieve this, the CASB established the following fundamental requirements: [Ref. 6: Subpart 30.418-40]

a. A business unit shall have a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied.

b. Indirect costs shall be accumulated in indirect cost pools which are homogeneous.

c. Pooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives.

Also included in the requirements was definitive guidance on the allocation base to be selected. While the researcher feels that it is not necessary for the purposes of this study to include that guidance here, it is interesting to note that the requirements on allocation base selection were by far more definitive than had ever appeared before in a Government regulation. It was also the subject of much criticism by Industry representatives who feared it would require significant changes in their cost accounting practices. However, the CASB concluded that definitive guidance in this area was necessary in order to achieve the level of uniformity and consistency that was desired.

However, in another area but somewhat related, the CASB did agree with the criticisms made by Industry. It had to do with the concept of materiality and the unnecessary proliferation of expense pools and changes in cost accounting practices, and the substantial costs that such changes would generate without producing any practical impact on Government contract costs. In the prefatory comments to CAS 418 the CASB addressed this issue by saying: [Ref. 3: p. 343]

> . . . the Board recognizes that this Standard may have a pervasive impact on contractor accounting systems. Because of this, the Board here and in the Standard is emphasizing the necessity to evaluate any perceived need for change in cost accounting practices in terms of materiality. The need to evaluate the materiality of a change in cost accounting practice applies to all provisions of the Standard. It is not limited to those particular provisions of the Standard in which materiality is mentioned for emphasis.

These strong comments certainly indicate that the CASB was concerned that implementation of CAS 418 would mean unnecessary and costly changes in contractor´s cost accounting practices. The comment emphasizes that above all else, auditors and contracting officers must evaluate the materiality of the situation before concluding that CAS 418 requires the contractor to make a change in cost accounting practice.

K. INTERPRETATIONS OF CAS 418

The researcher could not identify through the FLITE research system any significant interpretations of CAS 418 that have come to the litigation or disputes stage. The reason for this could be that the requirements of CAS 418 are covered in much more specific terms under other Cost Accounting Standards dealing with cost allocation, such as CAS 403, 410 and 420. These other standards would then be more useful to the auditor. Whatever the reason, there has been little open dispute over CAS 418. However, the DCAA did promulgate interpretative guidance to its auditors on CAS 418.

In regard to the requirement for a written statement of policy for classifying costs as direct or indirect, DCAA concluded that the auditor should review the Disclosure Statement for the necessary information. Only if the Disclosure Statement was insufficient should the auditor request additional detail. Part III, "Direct vs. Indirect," Item 3.1.0, of the Disclosure Statement should serve this purpose for most contractors and relieve them of unnecessary duplication of effort.

On the subject of materiality, DCAA advised its auditors that, "the creation of additional indirect cost pools should be required only if changes will result in materially different cost allocations." Also, "homogeneity of indirect

cost pools is a significant requirement of the standard; however, a pool may be considered homogeneous if the separate allocation of costs of the dissimilar activities would not result in a materially different allocation of cost to cost objectives." [Ref. 4: p. 871] The materiality criteria to be used by DCAA are contained in FAR Part 30.305.

DCAA, just as the CASB had intended, has advised its auditors that materiality is a priority when applying CAS 418. They have reemphasized what the CASB had stated in its prefatory comments, recognizing that there is no need to require costly changes in cost accounting practices if no material change in cost allocation will result.

L. SUMMARY

This chapter has presented background on the establishment of the CASB as well as detail on four of the Standards promulgated by the Board. The CASB was established by Congress in order to apply uniformity and consistency in the cost accounting practices employed by contractors. The CASB understood their role not as one to dictate specific cost accounting practices to be used but rather ensuring the consistent and equitable application of the practice once it was chosen. The key to success of having Cost Accounting Standards is for Government and Industry to be able to

understand and interpret them in unison as the CASB had intended.

A full discussion has been presented of each of the four Standards that will be profiled in subsequent chapters. This included the specific requirements imposed by the CASB and some examples of the different ways that each Standard could be interpreted and implemented by both Government and Industry. This should give the reader a good feel for the types of issues that exist in the application of the Cost Accounting Standards.

Each one of the Standards profiled in this chapter has been a problem for the American Electronics Corporation. The problems concern implementation and interpretation issues that involve the company, DCAA, and the ACO. The following three chapters will each contain a separate case study of a CAS non-compliance, focusing on these issues and their eventual resolution.

III. CASE 1: COST ACCOUNTING STANDARDS 401 AND 402

A. INTRODUCTION

The purpose of this chapter is to introduce the company which is the subject of these case studies, and then present the first Cost Accounting Standards non-compliance case. The information presented on the company's background is pertinent for all the cases involved in this study, and will not be repeated in subsequent chapters.

The first case involves Cost Accounting Standards 401 and 402, which are presented together because the company was charged with non-compliance of these two Standards on one particular issue. The facts of the case will be presented in detail from the time the initial finding was first reported through to the final negotiation and settlement. This will then be followed by a summary and analysis of the issues in this case.

B. BACKGROUND ON AMERICAN ELECTRONICS CORPORATION (AEC)

American Electronics Corporation (AEC) was founded in Northern California in 1966 and has steadily grown to become a leader in the design, manufacture and operation of electronic and computer systems. These systems provide a

variety of functions including satellite communications, navigation, earth observation, and tracking, telemetry and control for both fixed stations as well as ground mobile and airborne users. In addition, the company performs important system engineering functions in the design of the next-generation air traffic control systems, and major new NASA and DOD space programs. AEC does about 40 percent of its sales both as a prime and subcontractor with the U.S. Government and the remainder with commercial customers.

AEC is comprised of two separate divisions, System Engineering and Space Systems, with major plants in four U.S. cities. The largest plant and main corporate headquarters is located in Northern California where the majority of Government contract work is performed. Seventy-five percent of total Government contract work performed by AEC is considered subcontract work, the majority of which is contracted with major companies such as Raytheon Company and Grumman Aerospace Corporation.

AEC was originally incorporated under the laws of the State of California, however, in 1977 it was reincorporated as a Delaware corporation. The company stock is traded over-the-counter and it is set up under what the Board of Directors calls a "Corporate Partnership" (CorPar). This allows the company to enjoy the simplicity, flexibility, and efficiency

of a partnership framework, while retaining the protective features of the corporation. The CorPar is a simulated partnership between shareholders and workers based on corporate operation externally and partnership operation internally.

Under this CorPar concept, gross company revenues are divided into three categories: (1) basic business costs, (2) preservation costs, and (3) profits. Basic business costs and preservation costs have first and second priorities, respectively, against gross revenues.

Basic business costs include all costs of material and services, insurance, taxes, compensation for the employees and compensation for the shareholders. Base compensation for each employee is determined yearly as a result of the employee evaluation process. Base compensation for each shareholder is equivalent to a stated rate of interest applied to each shareholder's share of the net worth of the company at the beginning of the fiscal year. At the discretion of the Board of Directors, the base compensation may be distributed by the payment of cash dividends or by reinvestment in the company.

Preservation costs are the expenses of providing those services which contribute to the well-being of the employees and to the maintenance of adequate facilities and capital. Included in preservation costs are provisions for seniority

recognition, personnel maintenance and development, and retirement.

Under CorPar, profits are determined at the end of each fiscal year and allocated to the shareholder and employee partners in proportion to the relative value of the contribution of each to the combined endeavor. Sharable profits are determined by subtracting the basic business and preservation costs from gross revenues. Sharable profits, if any, are divided annually between the employee and shareholder members according to their respective capital values. The net worth of the company and the total base salaries of the employees are used to determine the relative capital values. Each employee´s total compensation is the sum of his base compensation, his proportional share of preservation costs for employee benefits and services and his portion of sharable profits. It is interesting to note that any adverse cost impact associated with a CAS non-compliance will directly affect an employees´ compensation. Each shareholder´s total compensation is the sum of the base compensation on his investment, his proportional share of facility preservation and his portion of sharable profits.

After joining AEC, an employee serves a two year probationary period before becoming a regular member of the company. After successful completion of the two year

probationary period, the individual becomes a regular member placed on the master rating list which ranks all members in the order of their value to the company. Each regular member takes part in the annual member evaluation program. A system which serves as a kind of internal management control device. Each member anonymously evaluates the work and attitude of all in the department (including him or herself), then ranks each member of the department (including him or herself) in what is felt to be their order of value to the company. This data, together with similar information from the department supervisor, is given to the Member Evaluation Committee. This committee, composed of company officials, executives and supervisory personnel, fits the regular members from all departments into a single list in the order of their relative value to the company. The position on the master rating list determines the relationship of one's basic wage to the wage of others on the list.

Exhibit 3-1 displays a summary of the overall financial position of AEC over the last three years:

Exhibit 3-1

AEC'S FINANCIAL POSITION

(In thousands)	1990 YEAR END	1989 YEAR END	1988 YEAR END
Net Billings	340,128	299,789	277,656
Net Earnings	29,439	25,503	24,242
(In $ per share)			
Net Earnings	10.74	9.28	8.83
Cash Dividends Paid	3.35	2.90	2.50
Shareholders' Equity	70.78	62.95	56.77
Number of Employees	3,673	3,317	3,180
Number of Shareholders	2,209	2,084	1,919

AEC is in solid financial condition in terms of cash flow, debt management and profitability. Net earnings have increased over 20 percent in the last three years as a result of a corresponding increase in sales. Dividends have been paid out at a fairly consistent rate of about 30 to 35 percent of net earnings with the balance being reinvested in the company for future growth.

The cost accounting system used by AEC is a standard cost system. In a standard cost system, standard costs instead of actual costs are part of the formal accounting recordkeeping system. The use of standard costs in the accounting records means that standard costs will be used for product costing and can greatly reduce the complexity of product costing for inventory valuation. Under standard costing, the value of inventory is the number of units times the standard cost per

unit. Only if the variance is "material" will the variance have to be allocated. This reduces the clerical work needed to value inventories because detailed records of the actual cost per unit are not kept.

C. INITIAL FINDING OF NON-COMPLIANCE

On 30 June 1985, DCAA conducted an audit of proposed costs that AEC had submitted in their bid for a subcontract to recertify certain component parts. During the audit, the DCAA auditor conducted a routine evaluation to determine if AEC was in compliance with the CASB's rules, regulations and standards. The results of the audit concluded that AEC was in non-compliance with CAS 401 and CAS 402. This was formally reported to the ACO by letter on 19 August 1985.

What the auditor found was that AEC had included in this proposal a charge for "Other Costs" which amounted to an arbitrary application of a 50 percent factor to total manufacturing costs. The auditor found no basis for the charge and was told that it was added to recover the additional costs of handling and stocking of parts. Since no historical records were maintained to justify this practice the auditor concluded that AEC was in non-compliance with CAS 401, one of the consistency standards, which calls for proposing, reporting and recording costs on the same basis.

Further, the costs involved were not separately identified and were included in other areas of AEC's records for cost recovery, constituting double recovery, and non-compliance with CAS 402.

The auditor determined that this practice resulted in an overstatement of proposed costs on the immediate proposal of $170,424. This is illustrated in Exhibit 3-2, showing how the 50 percent factor was eliminated. Note that the exclusion of other costs also impacted the G&A costs allocated on the basis of total cost input. This total cost difference was $458.79 per unit. Also, the total price would likewise be affected.

The audit report recommended to the ACO that the contractor be required to submit a cost impact proposal for each and every CAS covered contract where it has employed the same practice. In a letter dated 5 September 1985, the ACO informed AEC of the findings of non-compliance with CAS 401 and 402, and requested that AEC review the findings and either provide concurrence or reasons why existing practices were in compliance. AEC's first response to the allegations of non-compliance with CAS 401 and 402 was submitted to the ACO on 4 October 1985. The short response indicated that a more thorough response refuting the allegations would be forthcoming within 60 days. AEC was in the process of

bringing in outside legal and accounting assistance to aid in their defense. However, this initial response did attempt to

Exhibit 3-2

DCAA AUDIT DETERMINED COST IMPACT (30 JUNE 1985)

	AEC Proposal (unit cost)		DCAA Audit Determined Cost
Material	$488.20		$488.20
Material Overhead (13.3%)	64.93		64.93
Labor	28.50		28.50
Labor Overhead (581%)	165.59		165.59
Total Mfg Cost	747.22		747.22
Other Cost (50%)	373.61		------
Total Cost	1120.83		747.22
G & A (22.8%)	255.55		170.37
Total Cost and G&A	1376.38		917.59
Profit (18.3%)	251.88		167.92
Total Price Per Unit	$1628.26		$1085.51
	========		========
Number of Units	314		314
Total Price	$511,274		$340,850
Difference in Price		$170,424	
		========	

make a case that the audit report was flawed by indicating three points:

a. Practices used to quote the recertification component prices are consistent with practices set forth in the disclosure statement.

b. Practices used by AEC do not result in double recovery.

c. Changes in practices would result in increased costs to the Government.

The main purpose of this initial response on the part of AEC was to let the ACO know that it disagreed with the audit findings and to give the ACO an opposing viewpoint to consider. The initial points made by AEC were very general and unsupported, but were included to try and put some doubt in the mind of the ACO. Meanwhile, AEC would be able to bring in experts to attempt to refute the allegations in detail.

D. DISPUTING THE CASE

On 9 December 1985, the ACO sent a letter to AEC requesting the formal reply that had been promised within 60 days. On 19 February 1986, having not received a reply from the company, the ACO again sent a letter requesting a formal reply. This letter was sent directly to the Vice President, indicating that a failure on the part of a contractor to furnish requested data gives the ACO the unilateral right to determine the cost impact of the non-compliance issued on contracts/subcontracts and withhold up to 10 percent payment on all CAS covered contracts/subcontracts. At the time, this meant that up to seven million dollars could have been withheld. AEC immediately requested in writing an extension until 1 April 1986, which was granted.

AEC finally responded on 26 March 1986, again denying that they were in non-compliance with CAS 401 and 402. Their first

point was that the costs in question, namely material/spare parts handling costs, were all valid costs that the company should be able to recover. Especially, they noted, when the contract involves component parts, because these parts incur extraordinarily large handling costs thus the needed 50 percent factor. Further, they point out that "this position has been clearly supported by the Navy," and "this customer recognized that such types of sales do indeed entail additional amounts and types of costs, and recognizes that a cost increment is appropriate." AEC felt that since the Navy, who they did most of their DOD business with, had no problem with this practice in the past, then why should it be a problem now.

Addressing the allegation of non-compliance with CAS 402, they stated:

> We feel the auditor errs in suggesting that this practice results in double recovery. This is because the base on which the estimated costs and overheads were generated includes consistent application of this pricing practice. If, and only if, changes were being made in the approach to pricing which included such an increment, would the auditor be correct. Since this is obviously not the case, we reject his allegation and the attendant notion that the approach is inconsistent with CAS 402.

Basically, AEC is saying that since they have been consistently using this practice and have not changed in any way their approach to pricing, then they comply with CAS 402.

Their view was that the Standard called for consistent application of pricing and that is what they were doing.

Addressing the allegation of non-compliance with CAS 401, they stated:

> It is agreed that costs are not recorded in the manner interpreted by the auditor. However, it is felt that the practice should not be construed as a CAS violation. The audit report seems to suggest that costs which are not physically booked or allocated to cost objectives constitute CAS violations, and that the only acceptable form of accounting system is one which identifies and records all direct and allocated costs to contract. Such logic seems to say that a direct standard cost system cannot be considered in compliance with CAS. We strongly disagree with the audit report position regarding the CAS 401 allegation, since we feel that our current practices should in no way be construed as being in violation of this standard.

AEC´s argument on the CAS 401 issue focuses on the fact that they felt that the auditor found them in non-compliance because of the cost accounting system that they were using. The standard cost system that they use allows them to be less detailed in their recordskeeping, and so they felt it to be unnecessary to keep track of these material handling costs. AEC´s argument was that the Cost Accounting Standards didn´t prohibit the use of a standard cost system, so using one could not put the company in non-compliance.

After reviewing these arguments, DCAA in their audit report dated 19 May 1986, concluded that the contractor was

still in non-compliance with both CAS 401 and 402. In regard to the CAS 401 issue, the auditor makes clear that AEC's accounting system is not at issue. The issue is the development of the rate used to estimate the material handling costs. The auditor contends that AEC has already made modifications to its accounting system in order to use actual costs for forward pricing purposes (i.e., development of overhead rates prior to upcoming year in order to cost proposals) instead of costs generated by the standard cost system. There should be no difference in the development of a pricing rate for material handling costs. Currently, AEC does not maintain any type of records which support the rate used in the proposal, therefore they are in non-compliance with CAS 401.

In regard to the CAS 402 issue, the auditor agrees that these costs may be necessary and recoverable, but the consistent application of a pricing practice that results in double recovery is not appropriate. The forward pricing rates used to estimate overhead include all costs of the departments that provide the services in question, including those historical costs specifically related to the services in question. Since all of these costs are recovered through the forward pricing rates, any additional provision for the recovery of these costs constitutes a double recovery.

Therefore, when the subcontractor proposed an arbitrary factor of 50 percent of base input costs it was in non-compliance with CAS 402.

After reading the audit report, the ACO was now fully confident of the Government's position and issued a formal finding of non-compliance with both CAS 401 and 402 on 13 August 1986. This letter requested that AEC submit a cost impact proposal within 60 days. AEC subsequently requested in writing an extension until 15 December 1986, which was granted.

According to AEC's Supervisor of Pricing and Cost Analysis, it was at this point that AEC came to the realization that they weren't going to be able to convince either DCAA or the ACO that their cost accounting practices were completely consistent with CAS 401 and 402. He further indicated that their new strategy would now be to show that while their cost accounting practices may not be consistent with CAS, if they were forced to change practices in order to recover these costs in a manner consistent with CAS, it would end up costing the Government more in future contracts. AEC was hoping that the ACO would then drop the issue.[1]

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[1]From personal interview conducted with the company's Supervisor of Pricing and Cost Analysis.

The approach used by AEC was to calculate multiple overhead rates for development effort, complete units and component parts based on actual FY86 results. As opposed to the company´s actual practice which was to calculate a single set of rates for all products it was selling (be it development effort, complete units or component parts), and if the product involved component parts to use the controversial 50 percent factor for "Other Costs". The approach of calculating a separate set of overhead rates would eliminate the need for the 50 percent factor by allowing the company to recover the costs through a revised overhead rate structure, and would also be in compliance with CAS. AEC took the new rates and applied them to all affected contracts occurring in FY86. This caused a cost increase to the Government of $2,476,750. AEC reported this to the ACO in a letter on 15 December 1986, which concluded by stating, "We suggest that a price increase in CAS-covered contracts in general is indeed detrimental to the interests of the Government, and that DCAA recommendations concerning accounting changes should be reconsidered."

Exhibit 3-3 illustrates how a change in the overhead rate structure, as proposed by AEC, can result in such a large increase in costs on Government contracts. AEC was awarded or was in the process of negotiating a total of 55 Government

contracts for 1986. Forty-five of these were for unit-type acquisitions and 10 of these were for component-type acquisitions. There were no contracts awarded or proposed for development effort. Only the contracts for the component-type acquisitions contained the 50 percent factor, so when the revised overhead rates are applied to unit-type contracts, the result is a price increase. This can be seen in Exhibit 3-3, where one unit-type contract is displayed with both the old rates and the new proposed rates. The difference in rates results in a price increase of $41,838 on that one contract.

Also displayed is one component-type contract. The new rates eliminate the 50 percent factor and apportion this charge to labor overhead which would increase 155.65 percent. However, the result of this is that the overall price would decline by $18,042 on this contract. This is the typical scenario for both types of contracts, however, because there were 35 more unit-type contracts which are generally of a much larger dollar value and involve larger quantities, the end result is a price increase in Government contracts of almost $2.5 million.

DCAA´s subsequent audit, dated 20 May 1987, completely disagreed with AEC´s cost impact proposal. The auditor felt that the AEC proposed rate restructuring went far beyond the

Exhibit 3-3

AEC DETERMINED COST IMPACT USING EXAMPLE CONTRACTS

Item	AEC Revised 1986 Rate Structure Unit	Component	Development	AEC Actual 1986 Rates
Material OH	11.54%	11.54%	N/A	11.54%
Labor OH	586.78%	700.94%	213.99%	545.29%
G & A	18.77%	28.94%	18.77%	22.21%
Profit	18.30%	18.30%	18.30%	18.30%

	Unit-Type Contract Actual	Revised	Component-Type Contract Actual	Revised
Material	$3,941	$3,941	$223	$223
Material OH	455	455	26	26
Labor	2,850	2,850	74	74
Labor OH	15,541	16,723	404	519
Total Mfg Cost	22,787	23,969	727	842
Other Cost	------	------	363	---
Total Cost	22,787	23,969	1,090	842
G & A	5,061	4,499	242	244
Total Cost/G&A	27,848	28,468	1,332	1,086
Profit	5,096	5,210	244	199
Total Price	$32,944	$33,678	$1,576	$1,285

Unit-Type Contract: $33,678 - $32,944 = $734 x 57units
$41,838 price increase to Government

Component-Type Contract: $1,576 - $1,285 = $291 x 62units
$18,042 price decrease to Government

Net Price Increase to Government: $23,796

two CAS issues at hand. In order to stick to the issues, AEC basically had two choices if it wished to comply with CAS. First, they could throw out the 50 percent factor completely and forgo recovery of the costs. Second, they could develop a material handling rate substantiated by actual recorded data, which is called for in CAS 418 on indirect costs.

Using the same data that AEC used in its cost impact proposal, the auditor developed a material handling rate and adjusted labor overhead rate for all affected FY86 contracts as follows:

	AEC 1986 Rates	Auditor´s 1986 Rates
Material Overhead	11.54%	11.54%
Labor Overhead	545.29%	551.72%
Other Direct Costs	50.00%	12.50%
G & A	22.21%	22.21%
Profit	18.30%	18.30%

The auditor then applied these rates to the 55 applicable contracts for 1986 with the following results:

	Cost Impact
Unit-Type Contracts (45)	($892,844)
Component-Type Contracts (10)	$690,478
Net Increase	($202,366)

A net increase in cost to the Government of $202,366. The auditor concurred with AEC that in FY86 if AEC had been in compliance with CAS by developing a substantiated materials handling rate, the result would have been an increase in cost to the Government. However, the magnitude of that increase is quite different, and in subsequent years with varying levels of contract mix and current year rates those negative results could change.

After addressing the method proposed by AEC to comply with CAS, the auditor then addressed the actual validity of the cost impact. In accordance with the terms of FAR, cost impact for CAS non-compliance should be computed by using the difference between the contract price agreed to and the contract price that would have been agreed to if the contractor had complied with the CAS requirements. Since at the time FY86 contracts were being negotiated there was no substantiating documentation to support any material handling rate, the contract price that would have been agreed to should be the final negotiated price less the amount attributed to the 50 percent arbitrary factor including the applicable portion of G&A and profit. In FY86, AEC had been awarded one negotiated contract that contained the 50 percent factor, for a total cost impact of $23,698. This is the figure that the auditor reported to the ACO as the actual cost impact attributed to the non-compliance for FY86.

The ACO, on 3 March 1988, went back to AEC with a letter requesting a revised cost impact proposal based on all FY86 and FY87 negotiated contracts containing the 50 percent factor. It is worth noting that it took over 14 months for the Government to respond to AEC's 15 December 1986 cost impact proposal. This was due in part to a slow response by DCAA, attributed to manpower shortages at the time, and a

changeover of ACOs that resulted in this particular issue being buried until the new ACO could get up to speed on all aspects of the job.

E. RESOLUTION

According to AEC´s Supervisor of Pricing and Cost Analysis, at this point AEC recognized that they weren´t going to be able to convince the ACO or DCAA to drop the non-compliance issues, and further, they were advised by outside counsel that appealing this case to the ASBCA or other court would not be worth the cost. They decided to go along with DCAA but attempt to minimize the damage as much as possible.[2]

On 20 May 1988, AEC provided the ACO with the cost impact for FY86 and FY87 affected contracts. In their response it was noted that FY86 had been calculated by DCAA as $23,698 and since no other FY86 contracts were applicable this was their cost impact for FY86. For FY87, AEC provided a listing of all Government proposals for component parts which were negotiated and were originally proposed with "Other Costs". Of this list, it was noted that only two proposals were negotiated with "Other Costs" remaining. The total cost impact if "Other Costs" were removed, including the applicable portion of G&A

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[2] From personal interview conducted with the company´s Supervisor of Pricing and Cost Analysis.

and profit, was proposed at $64,415. The total cost impact proposed by AEC for FY86 and FY87 was $88,113.

On 9 January 1989, DCAA provided their audit of AEC's latest cost impact proposal. This time the auditor wanted to verify that AEC had included all applicable contracts in their cost impact proposal. After a complete review of the ACO's files, coupled with coordination and verification with the cognizant buying offices, the auditor found five additional contracts from FY87 and one additional contract from FY86 that should have been included in the contractor's cost impact proposal. The discrepancy was attributed by the auditor to the fact that in those instances where the contract was negotiated on a bottomline basis, the contractor's negotiation files did not show any amounts for "Other Costs". However, the data provided by representatives of the buying offices did identify the amounts negotiated for "Other Costs".

The new cost impact as calculated by the auditor totaled $303,237. This consisted of the actual cost impact of $288,368 plus interest of $14,869. Interest was also omitted from AEC's cost impact proposal but is required per FAR 52.230-3. The auditor also went further and recommended to the ACO that AEC submit a cost impact for FY85 since the practice of using the arbitrary 50 percent factor was started in 1985.

The ACO concurred with the auditor, and on 14 April 1989, sent a letter to AEC informing them of the six contracts discovered by the auditor. In addition, the ACO requested a complete cost impact including FY85 affected contracts be submitted within 30 days. AEC subsequently requested and was granted an extension until 9 June 1989.

On 7 June 1989, AEC responded in complete agreement with DCAA. This time they provided a copy of all applicable contracts from FY85, FY86 and FY87 and proposed a cost impact (less interest) of $300,898. Which, they pointed out, exceeded the DCAA recommendation (less interest) of $288,368. Their proposal also included the DCAA recommendation for interest of $14,869. This made AEC's total cost impact proposal $315,767.

In reality, AEC did not and still does not agree with the inclusion of many of the contracts in the cost impact proposal. However, to preclude DCAA from digging even deeper into their files, AEC felt it was a good time to cut their losses and get the issue resolved.[3]

The final DCAA audit, submitted to the ACO on 15 November 1989, questioned only one element of AEC's cost impact. The auditor recalculated the amount of interest through 31 October

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[3]From personal interview with the company's Supervisor of Pricing and Cost Analysis.

1989, and came up with an adjusted interest charge of $27,160. The difference being an additional $12,291, raising the total cost impact to $328,058. The auditor concluded however, that AEC's cost impact proposal was acceptable for negotiating a resolution to the non-compliance with CAS 401 and 402.

Negotiations between the Government and AEC were conducted on 2 May 1990. The Government was represented by the ACO and a DCAA auditor. AEC was represented by the Supervisor, Cost Analysis and Government Accounting, and the Manager of Government Accounting. During the negotiations the following points were clarified and agreed on:

a. It was confirmed by AEC that the questionable practice of using the unsubstantiated 50 percent factor for "Other Costs" was corrected in October 1987.

b. AEC confirmed that the listing of contracts used to compute the cost impact was complete. The ACO also requested, and AEC agreed, to certify that the listing is complete to the best of their knowledge, and if other affected contracts were discovered in the future, AEC would agree to re-open negotiations and reimburse the Government for overcharges at that time.

c. It was agreed that an offset of other open contracts would be the vehicle for recovery, and a Letter of Agreement would be executed which would include the certification discussed in paragraph b above.

d. AEC's proposal for the overcharge of $300,898 was accepted.

e. The interest charge agreed on totaled $46,722 computed as follows:

(1) The midpoint of contract shipments over the life of each affected contract would be used as the starting point for interest calculations and interest would accrue up to the time the adjustment is affected, 1 June 1990.

(2) Prior to August 1986, the Cost Accounting Standards clause stated that the interest rate would be the treasury rate or seven percent, whichever was less. FAC 84-21 dated 29 August 1986, eliminated the seven percent cap on interest. During the negotiations it was agreed that for all 1985 and 1986 contracts, seven percent would be used (the actual treasury rate was higher for these years), and for all 1987 contracts, the actual treasury rate would be used.

(3) The compound interest method would be used, computed on the auditor developed figure for cost impact of $288,368.

When negotiations were completed, the total cost impact agreed to by both parties was $347,620

F. SUMMARY

Following the exact letter of CAS 401, CAS 402 and other pertinent regulations, the Government had a valid case for the prosecution of non-compliance and eventual recovery of costs. AEC had in fact not maintained historical records to substantiate the 50 percent factor used to estimate "Other Costs", and they were in fact recovering some of these costs through the existing overhead structure. This would no doubt lead one to the logical conclusion that they were in non-compliance with both CAS 401 and 402. AEC´s attempts to

mitigate the issues were unsuccessful in the face of persistent and highly capable DCAA auditors. Eventually, even outside accounting and legal counsel obtained by AEC to aid in their defense succumbed to the realization that the practice was non-compliant, and pursuing their line of argument further would be fruitless.

AEC argued that there were additional material handling costs associated with the sale of component parts (receiving, stocking, issuing, obsolescence), above that which was normally recovered for other types of sales. Further, they argued that their accounting system (a standard cost system) was set up to preclude detailed recordskeeping, which was less costly for them and fit in well with their predominant commercial business. It was also shown by the DCAA auditor that by applying 1986 actual data, the development of a material handling rate, which would be in compliance with CAS, would result in an overall cost increase to the Government.

This shows two things about AEC and the issues involved here. First, that they were correct in asserting that there were additional recoverable costs associated with the handling of materiel. Second, that they were not attempting to defraud the Government in any way, but instead were using judgement instead of more detailed and substantiated accounting data to

estimate valid costs. In 1986, the result of this practice was detrimental to themselves.

There are two issues that the Government must deal with in any CAS case. The first is seeing to it that the accounting practice is changed to conform with CAS, and the second is the cost impact/recovery. Both are important, however, in the absence of fraud the primary emphasis in implementing CAS should be to ensure that the accounting practice is changed to conform with CAS.

In the case of AEC, the non-conforming accounting practice was discovered in June 1985, but wasn't corrected until October 1987. Throughout this time, AEC was engaged in negotiating contracts using the non-conforming accounting practice, with the ACO and DCAA auditors fully aware of this. From the very beginning, the emphasis was placed on cost impact and cost recovery instead of correcting the practice. Nowhere in any of the DCAA audit reports submitted over the five years of this case did the auditors ever discuss actions that the company was taking or not taking to correct the accounting practice. The ACO and the auditor were concerned only with the validity of the cost impact proposal.

AEC dragged their feet in resolving the issue because they felt justified in collecting the additional costs associated with material handling, and wanted to minimize the negative

cost impact they knew would occur as a result of these CAS non-compliances. From AEC´s viewpoint, correcting the accounting practice immediately would have been an admission of guilt and would have made the mitigation of cost impact that much more difficult.

Once the Government can satisfy itself that the actual cost impact is not detrimental to the Government, then the focus should be on correcting the accounting practice in order to provide uniformity and consistency for future contracts. It was clearly shown using 1986 data that the material handling costs associated with contracts for component parts were above that normally recovered through the regular overhead accounts. Further, that these costs were valid recoverable costs and if documented properly could be recovered in full. The actual cost impact would have been additional costs to the Government if these costs had been documented properly. This was pointed out by AEC (though inflated) and verified by the DCAA auditor.

Instead of examining the validity of the costs and the actual historical cost impact, the Government looks only at what would have been negotiated if the costs associated with the non-conforming practice had been excluded completely. More times than not this will result in a negative cost impact

to the company, which will always put the company on the defensive and end up dragging out the resolution for years.

In this case, if the Government had concentrated its efforts on ensuring correction of the accounting practice instead of the recovery of costs, that in actuality were valid, then much time, effort and money could have been saved by both parties. In addition and probably more importantly, the spirit of CAS, to achieve uniformity and consistency in cost accounting practices could have been realized sooner.

IV. CASE 2: COST ACCOUNTING STANDARD 405

A. INTRODUCTION

The purpose of this chapter is to present the second Cost Accounting Standard non-compliance case involving American Electronics Corporation (AEC). Background on the company was presented in Chapter III, and will not be repeated here. This case involves Cost Accounting Standard 405, Accounting For Unallowable Costs. The facts of the case will be presented in detail from the time the initial finding was first reported through to the final negotiation and settlement. This will then be followed by a summary and analysis of the issues in this case.

B. INITIAL FINDING OF NON-COMPLIANCE

On 27 February 1987, DCAA conducted an audit of proposed costs that AEC had submitted in their bid for a subcontract. The ensuing audit report concluded that in the area of compliance with the Cost Accounting Standards, AEC was in non-compliance with CAS 405. This was formally reported to the ACO by letter dated 27 April 1987.

The auditor had discovered that AEC was not excluding unallowable costs for its on-site cafeteria. The cafeteria

was not generating sufficient revenues to cover its operating costs. Its loss from operation was subsidized by the company. Per FAR Subpart 31.205-13(b), contractors´ food service operations should be operated with the express intention of breaking even. This means that the operation of the cafeteria at AEC must pay for itself, and any loss incurred cannot be charged against Government contracts.

The estimated cost impact reported by the auditor was $195,000, calculated as follows:

Total Direct Labor 1987	$8,883,000
Estimated Direct Labor % on Govt Contracts	30%
Estimated Direct Labor $ on Govt Contracts	$2,664,000
% of Overhead Rate Related to Cafeteria Excess Costs	73%
Cost Impact	$195,000

Annual total direct labor dollars for AEC were about $8,883,000. At the time of this finding it was estimated that about 30 percent of AEC´s business was with the Government, so total direct labor dollars attributed to Government contracts was $2,664,000. AEC had included $646,000 of these unallowable cafeteria expenses as part of its total overhead pool of $51,607,000, which has an estimated impact of about 7.3 percent of the proposed 581 percent rate ($51.607M divided

by $8.883M direct labor costs). This makes the anticipated cost impact about $195,000.

In a letter dated 14 May 1987, the ACO informed AEC of the finding of non-compliance with CAS 405. The ACO requested that within 30 days AEC provide concurrence/non-concurrence with the initial finding and either submit a cost impact proposal or reasons why existing practices should be considered to be in compliance.

AEC responded by letter on 23 June 1987, refuting the allegations of non-compliance. They did not deny charging the cafeteria expenses to Government contracts, but rather tried to justify the inclusion of these costs as necessary to the operation of the business. The reply stated:

> It is our contention that AEC cafeteria expenses are reasonable and should be considered allowable based on the unusual circumstances that exist. For instance, AEC base pay rates are below the industry standard. Because of lower base pay rates, the company offers an attractive fringe benefits program to compete in today's labor market for qualified individuals. The resulting benefit to AEC and, ultimately, the Government are lower direct labor costs.
>
> Based on costs to run the cafeteria, we estimated that we spend about $500 per member to operate the AEC cafeteria. If AEC discontinued the cafeteria benefit, the cost to members to go outside for lunch would be over $1,000 per member, based on average meal prices for comparable meals outside the company. However, the low-cost cafeteria program, which we consider as a fringe benefit, is appealing because it translates into a benefit to the members that is worth more than the cost itself. This is evidenced by our continued subsidy to the members despite new withholding tax requirements. If AEC did not offer

this type of benefit, the base wages would be adjusted to compensate for this loss in benefits.

Another benefit of the in-house cafeteria is that it allows the company flexibility in scheduling sufficient time for lunch breaks of 30 minutes instead of one hour. The results of this scheduling are two-fold:

(1) Less member tardiness, and

(2) Increased daily productivity per member.

AEC also believes that offering well-balanced nutritious meals has resulted in better health and increased morale of its members, leading to better sustained performance.

AEC recommends that the cafeteria costs should remain in the FY87 forward pricing rates, and should be subject to negotiations on an individual contract basis.

AEC´s Supervisor of Pricing and Cost Analysis, indicated that AEC felt very strongly about their position on this issue. The main reason was the possible affect on pricing for commercial contracts. AEC knew that if the Government disallowed these costs, then AEC´s commercial customers who paid close attention to Government costing policies, would strongly object to being charged for these cafeteria costs. If AEC could not recoup these costs, then the only way to eliminate the problem would be to raise prices in the cafeteria. AEC did pay its employees below industry standard, but made up for it with an above average benefits package,

including the cafeteria. This would all but eliminate one portion of that benefit package.[4]

The ensuing DCAA audit, dated 14 August 1987, was unfavorable for AEC. The auditor did not comment on AEC's argument, but rather simply stated that after researching the FAR and other Government regulations, nothing could be found that would make these costs allowable.

The ACO concurred with the DCAA audit and issued a determination of non-compliance with CAS 405 to AEC on 2 March 1988. The ACO gave AEC 30 days to submit a cost impact statement. AEC requested in writing an extension until 10 July 1988, which was granted.

C. DISPUTING THE CASE

AEC responded on 17 June 1988, but did not submit a cost impact statement. Instead, they attempted to refute the determination of non-compliance made by the ACO, and requested reconsideration based on the following information:

> 1. The cafeteria costs that DCAA has claimed to be unallowable are not explicitly stated in the cost principles (FAR Part 31) as unallowable costs.
>
> 2. DCAA has reviewed our forward pricing rates on an annual basis and have never questioned our cafeteria costs previously.

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[4]From personal interview conducted with the company's Supervisor of Pricing and Cost Analysis.

3. As stated in our 23 June 1987 letter, unrecovered cafeteria costs are part of the benefit package offered to our employees. Since January 1987, the employees who have utilized our cafeteria have paid federal and state income taxes on the unrecovered portion of their meals. The system used to tax members for benefits received from the cafeteria was established to meet requirements of the Tax Reform Act of 1984. All direct costs, as defined by IRS guidelines, are recovered from cafeteria receipts. The DCAA auditor stated in recent telephone conversations that he was unaware of this change during his review of our FY87 rates, and subsequent evaluation of our reply to initial findings of non-compliance.

DCAA reviewed this latest attempt by AEC to refute the determination of non-compliance, and on 12 September 1988, released an audit report addressing each of the points raised by AEC. The audit report also included an estimated cost impact for all the years involved.

In regard to their first point, in which AEC asserted that cafeteria costs are not explicitly unallowable under the cost principles, DCAA´s response was:

CAS 405.40(a) states that costs expressly unallowable shall be identified and excluded from any billing, claim or proposal applicable to a Government contract. Unallowable costs are defined as any costs which under the provisions of any pertinent law, regulation, or contract, cannot be included in prices, cost reimbursements or settlements under a Government contract to which it is allocable.

The losses from the cafeteria are unallowable because it was not the contractor´s objective to operate the cafeteria on a break-even basis as required by FAR 31.205-13(b). This regulation states that losses sustained because food services are furnished at prices which are below a break-even basis are unallowable.

In regard to their second point, in which AEC asserted that DCAA has never questioned cafeteria costs previously, DCAA´s response was:

> Although these costs were not previously questioned, this does not relieve the contractor of the requirement to comply with the provisions of CAS 405.40(a), which states in part that "unallowable costs shall be identified and excluded from claims, billings or proposals applicable to Government contracts." Thus, since the contractor has the responsibility to identify and exclude unallowable costs, the Government is not precluded from questioning such costs simply because these costs were not questioned in prior audits.

In regard to their third point, in which AEC asserted that effective 1 January 1987, employees have paid Federal and state income taxes on the unrecovered portion of their meals, DCAA´s response was:

> Under the current policy of requiring employees to report as income the subsidized portion of the meals, the contractor is in essence operating the cafeteria on a break-even basis as required by FAR 31.205-13. Thus, the estimated cost impact is based on losses incurred prior to the 1 January 1987 change.

The bottom line of all of this, as far as the Government is concerned, is that AEC is compliant with CAS 405 after 1 January 1987. However, prior to that, AEC was not in compliance with CAS 405 and must reimburse the Government in the amount of the cost impact as a result of the non-compliance.

The DCAA auditor determined that the inclusive time period of the cost impact should be FY85, FY86 and the first three months of FY87. Using actual data from this period of time, and employing the same methodology previously used, the auditor estimated the cost impact to be $564,523 calculated as shown in Exhibit 4-1. The basis for this calculation is an estimate of the direct labor used on Government contracts considering the percentage of Government business conducted by AEC. This will be a rough estimate at best, but it does give the ACO some idea of the amount in question.

Exhibit 4-1

DCAA ESTIMATED COST IMPACT (12 SEPTEMBER 1988)

	FY87 1st 3 Mths	FY86	FY85
Total Direct Labor Cost	$2,220,750	$9,367,000	$6,890,000
% of Government Sales	45.20%	35.50%	32.50%
Estimated Direct Labor on Govt Contracts	$1,003,779	$3,331,842	$2,239,250
% of Overhead Rate Related to Cafeteria Expense Below Break-Even Point	8.4%	8.7%	8.5%
Cost Impact	$84,317	$289,870	$190,336
	==========	==========	==========

Total Cost Impact (FY87,FY86,FY85) - $564,523

The ACO concurred with DCAA's position, and on 8 December 1988, sent a letter to AEC delineating the Government's position and requested a cost impact statement for FY85 through the first quarter of FY87 be submitted within 30 days.

AEC requested in writing an extension until 3 February 1989, which was granted.

AEC submitted their first cost impact statement on 7 February 1989. The total amount proposed by AEC as the cost impact for non-compliance with CAS 405 was $3,388.25, obviously well below the estimates calculated by DCAA. In order to arrive at this figure, AEC first calculated what they thought were the applicable amount of cafeteria costs for the three fiscal years involved. Then, they removed these costs from the labor overhead pool and G&A cost input base to arrive at revised rates for labor overhead and G&A. The combined affect was to lower the labor overhead rate and offset this with an increase in the G&A rate. The resulting change in rates looked like this:

Labor Overhead Rates

	FY85	FY86	FY87
Before	447.4%	421.3%	581.0%
Adjusted	442.3%	417.2%	576.8%

G & A Rates

	FY85	FY86	FY87
Before	28.1%	24.4%	23.3%
Adjusted	28.2%	24.6%	23.4%

The increase in the G&A rate was not as much as the decrease in the labor overhead rate, however, when applied to the total cost input this amount would serve to sufficiently

offset the decrease in labor overhead. The result, as planned by AEC, would be minimal cost impact.

The final steps in AEC's cost impact methodology were the identification of applicable contracts, and the determination of the effects of the adjusted rates. In order to choose the contracts to include, AEC stated in their letter:

> We reviewed for cost impact all proposals and negotiations during this time frame that resulted in CAS covered contracts. In those situations where "bottom line negotiations" took place, our records show that slight changes from rate adjustments (in most cases less than one percent) were more than offset by a substantial AEC price concession in the negotiated contract; therefore, we did not consider any further reductions for CAS 405 impact. However, you will note that we have adjusted several contracts for impact plus profit where this level of negotiation activity did not occur.

AEC identified four contracts from FY86, and no contracts from either FY85 or FY87 for cost impact purposes. The total cost impact was calculated as shown in Exhibit 4-2.

On 2 May 1989, DCAA submitted its audit report on AEC's cost impact proposal. The auditor's conclusion was that it was completely inadequate. The reasons as stated in the audit report were:

1. The contractor did not include all CAS covered contracts in effect during the applicable period.

2. The contractor excluded those contracts which were negotiated on a "bottom line" basis.

Exhibit 4-2

AEC COST IMPACT PROPOSAL (7 FEBRUARY 1989)

	Labor O/H	G & A	Total Net Difference
Contract #1			
Quoted	$2,881.14	$14,967.42	
Adjusted	$2,853.01	$15,059.36	
	-$28.08	+$91.94	+$63.86
Contract #2			
Quoted	$328,952	$129,142	
Adjusted	$325,741	$130,719	
	-$3,211	+$1,577	-$1,634.00
Contract #3			
Quoted	$296,949	$152,148	
Adjusted	$294,101	$153,997	
	-$2,848	+$1,849	-$999.00
Contract #4			
Quoted	$84,702	$44,800	
Adjusted	$83,878	$45,349	
	-$824	+$529	-$295.00
Net Total			-$2,864.14
Profit (18.3%)			524.11
			-$3,388.25
			==========

3. Certain marginal food services costs were eliminated from the computations.

4. The computed unallowable costs were also removed from the G&A base by the contractor which is in violation of FAR 31.203(c). This causes the G&A base to be understated and the G&A rate to be overstated.

The auditor was unable to obtain a complete list of CAS covered contracts and subcontracts for the affected period of time from either the contractor or the ACO. Neither keeps an adequate ready access data base of this information. As a result, the auditor again used an estimate of AEC's percentage of Government business to compute another more detailed cost

impact of the CAS 405 non-compliance. This time the auditor's overall estimated cost impact totaled $1,355,700, as shown in Exhibit 4-3.

The calculations in this estimate are much more detailed than the previous DCAA estimates, and include the effects on G&A and profit, and an interest charge. The reason for this estimate, as stated in the audit report, was to facilitate the ACO in negotiating a reasonable settlement. However, this latest estimate is well above the previous DCAA estimates and is so far above the AEC proposal that negotiation at this point would be impossible. After talking with both DCAA and AEC personnel, the researcher believes that the underlying reason for DCAA's latest estimate was to motivate the contractor to submit a realistic cost impact proposal which could be used as a basis for negotiation.

D. RESOLUTION

After the DCAA audit report was issued, AEC put together a list of CAS covered contracts and subcontracts which was sent to the ACO. Subsequently, on 11 July 1989, the ACO sent a letter to AEC requesting a revised Cost Impact Statement incorporating all the CAS covered contracts and subcontracts, and addressing all the issues raised in the DCAA audit report. A response was requested within 30 days.

Exhibit 4-3

DCAA ESTIMATED COST IMPACT (2 MAY 1989)

	FY 1985	FY 1986	FY 1987	Note
		($000 omitted)		
Labor Overhead	30,823.0	39,462.0	51,607.0	1
Less:Cafeteria Exp	803.2	835.2	789.8	2
Adjusted OH (A)	30,019.8	38,626.8	50,817.2	
Direct Labor (B)	6,890.0	9,367.0	8,883.0	1
Adjusted Overhead Rate (C)=(A/B)	435.7%	412.4%	572.1%	
Proposed O/H Rate (D)	447.4%	421.3%	581.0%	3
Questioned Rate (E)=(D-C)	11.7%	9.0%	8.9%	
Govt Portion of Direct Labor Base (F)	2,756.0	3,746.8	3,553.2	4
Unallowable Cost in Labor O/H (G)=(E*F)	322.4	336.0	317.2	
G & A Amount	90.6	82.0	73.9	5
Subtotal	413.0	418.0	391.1	
Profit (18.0%)	75.6	76.5	71.6	6
Subtotal	488.6	494.5	462.7	
Interest	136.8	103.9	64.8	7
Subtotal	625.4	598.4	527.5	
Less:FY87 Adjustment	-----	-----	395.6	8
Net Impact	625.4	598.4	131.9	

Total Cost Impact (FY85, FY86, FY87) - $1,355,700

Note 1. Figures obtained by auditor from AEC's records.
Note 2. Cafeteria expense represents the excess of costs over revenues for FY83, FY84 and FY85 increased by the projected growth of expenses (28.1%, 29.4%, 22.3%) as shown in AEC's records. In their proposal, AEC did not escalate cafeteria expenses to FY85, FY86 and FY87 dollars. Instead, they used the historical cost from FY83, FY84 and FY85.
Note 3. Rates are as shown in AEC's cost impact proposal.
Note 4. Estimated 40% of sales with Government.
Note 5. Amount represents application of the proposed rates of 28.1%, 24.4% and 23.3% respectively.
Note 6. Profit based on 18.3% rate proposed by AEC.
Note 7. Interest amounts are based on 28%, 21% and 14% factors for the respective years. These percentages are based on an annual rate of 7% for four, three and two years respectively.
Note 8. Based on non-compliance for 3 months in FY87.

According to AEC's Supervisor of Pricing and Cost Analysis, as a result of not wanting to be on the long end of a $1.3M judgement , AEC arranged a meeting with DCAA to reach an agreement on how exactly the cost impact statement should be developed[5]. An agreement was reached, and on 31 August 1989, AEC submitted a revised cost impact statement.

The methodology agreed to and employed by AEC was to calculate an adjusted labor overhead rate based on the exclusion of the unallowable cafeteria costs, and then apply this to the CAS covered contracts and subcontracts identified by AEC for FY85 through the first quarter of FY87. The calculations by AEC to arrive at the adjusted labor overhead rates are presented in Exhibit 4-4. The calculations to determine the bottom line cost impact for FY85 prime contracts, FY86 prime contracts and FY85-FY86 subcontracts is presented in Exhibits 4-5, 4-6 and 4-7 respectively. According to AEC's records, there were no contracts or subcontracts negotiated or awarded during the first quarter of FY87. The total cost impact proposed by AEC was $289,628.

In their letter to the ACO, AEC identified two problems which arose during the calculation of the cost impact proposal. The first was the lack of supporting cost breakdown

[5]From personal interview conducted with the company's Supervisor of Pricing and Cost Analysis.

documentation for contracts awarded below the cost or pricing data threshold. In regard to this, AEC proposed:

Exhibit 4-4

AEC RATE IMPACT SUMMARY

	FY 1985	FY 1986	FY 1987
Labor Overhead	$30,823,000	$39,462,000	$51,607,000
Less:Cafeteria Exp	539,700	570,100	553,400
Adjusted Overhead	30,283,300	38,891,900	51,053,600
Direct Labor Base	6,890,000	9,367,000	8,883,000
Adjusted Overhead Rate	439.5%	415.2%	574.7%
Proposed Overhead Rate	447.4%	421.3%	581.0%
Adjustment	7.9%	6.1%	6.3%

It was discovered that certain contracts were awarded without SF1411 supporting documentation, as certified cost or pricing data was not required if the proposed value was less than $500,000 and submitted before 1 April 1985. Upon thorough review of our files, cost breakdowns were not found. However, in order to determine a fair offer of impact on these CAS-covered contracts as well, we determined the average percentage of contract price reduction on those with SF1411 data on file and assessed this percentage to the total value of all other contracts.

The second problem encountered by AEC was the determination of the payment period to calculate interest owed. In regard to this, AEC proposed:

For the interest calculations, rather than review voluminous invoice historical files to determine payment period, we determined the midpoint of contract delivery schedules and compounded interest from this date to August 1989. Hopefully, you will concur with our assumption that this represents a reasonable payment period average, given that AEC has been responsive to your contractual delivery requirements.

Exhibit 4-5

COST IMPACT FOR CAS-COVERED PRIME CONTRACTS PLACED FY 1985

	Contract #1	Contract #2	Contract #3
Negotiated Price (A)	$1,053,000	$2,423,600	$240,604
	==========	==========	========
Negotiated Labor Base (B)	95,328	249,249	3,562
Overhead Adjustment From Exhibit 4-4 (C)	7.9%	6.1%	6.1%
Overhead Recovery (D=B*C)	7,531	15,204	217
G & A Rate (E)	28.1%	24.4%	24.4%
G & A Recovery (F=D*E)	2,116	3,710	53
Subtotal (G=D+F)	9,647	18,914	270
Negotiated Profit % (H)	16.1%	15.3%	15.0%
Profit Recovery (I=H*G)	1,553	2,894	41
Subtotal (J=G+I)	11,200	21,808	311
Interest (K)	2,521	4,908	70
Net Cost Impact (L=J+K)	$13,721	$26,716	$381
	=======	=======	======
Percent Reduction (L/A)	1.3%	1.1%	0.2%

Contracts Awarded Without SF1411´s (6 contracts)	
Total Price	$1,103,197
Proposed Percent Reduction	1.0%
Net Cost Impact	$11,032
Net Cost Impact Contract #1	13,721
Net Cost Impact Contract #2	26,716
Net Cost Impact Contract #3	381
Total Impact Proposed For FY 1985 Prime Contracts:	$51,850
	==========

The final DCAA audit report was submitted on 23 February 1990. In his report, the auditor concluded that the data presented by AEC in their latest proposal were acceptable for negotiating cost impact, however there were three exceptions noted by the auditor. First, was the universe of contracts used to determine the cost impact. The audit report stated

Exhibit 4-6

COST IMPACT FOR CAS-COVERED PRIME CONTRACTS PLACED FY 1986

	Contract #1	Contract #2	Contract #3
Negotiated Price (A)	$258,375	$916,050	$3,770,336
Negotiated Labor Base (B)	22,105	75,330	274,516
Overhead Adjustment From Exhibit 4-4 (C)	6.1%	6.1%	6.1%
Overhead Recovery (D=B*C)	1,348	4,595	16,745
G & A Rate (E)	24.4%	24.4%	24.4%
G & A Recovery (F=D*E)	329	1,121	4,086
Subtotal (G=D+F)	1,677	5,716	20,831
Negotiated Profit % (H)	13.1%	13.5%	12.0%
Profit Recovery (I=H*G)	220	772	2,500
Subtotal (J=G+I)	1,897	6,488	23,331
Interest (K)	273	1,200	2,507
Net Cost Impact (L=J+K)	$2,170	$7,688	$25,838
Percent Reduction (L/A)	0.8%	0.8%	0.7%

Contracts Awarded Without SF1411's (1 contract)	
Total Price	$121,624
Proposed Percent Reduction	0.8%
Net Cost Impact	973
Net Cost Impact Contract #1	2,170
Net Cost Impact Contract #2	7,688
Net Cost Impact Contract #3	25,838
Total Impact Proposed For FY 1986 Prime Contracts:	$36,669

that, "the results of audit are qualified as to the completeness and accuracy of the universe of CAS covered contracts since we do not have a Government maintained universe of CAS covered contracts, and accordingly we cannot be assured that the contractor has identified all CAS covered contracts."

Exhibit 4-7

COST IMPACT FOR CAS-COVERED SUBCONTRACTS PLACED FY 1985-86

	Cont #1	Cont #2	Cont #3	Cont #4
Negotiated Price (A)	$7,809.0	$13,830.6	$2,505.6	$2,981.9
Negotiated Labor Base (B)	553,069	1,045,583	231,552	230,975
Overhead Adjustment From Exhibit 4-4 (C)	6.1%	6.1%	6.1%	6.1%
Overhead Recovery (D=B*C)	33,737	63,781	14,125	14,089
G & A Rate (E)	24.4%	24.4%	24.4%	24.4%
G & A Recovery (F=D*E)	8,232	15,562	3,446	3,438
Subtotal (G=D+F)	41,969	79,343	17,571	17,527
Negotiated Profit % (H)	11.3%	12.0%	11.4%	17.0%
Profit Recovery (I=H*G)	4,743	9,521	2,003	2,980
Subtotal (J=G+I)	46,712	88,864	19,574	20,507
Interest (K)	6,769	12,876	2,836	2,971
Net Cost Impact (L=J+K)	$53,481	$101,740	$22,410	$23,478

Net Cost Impact Contract #1	$ 53,481
Net Cost Impact Contract #2	101,740
Net Cost Impact Contract #3	22,410
Net Cost Impact Contract #4	23,478
Total Impact Proposed For FY 1985-86 Subcontracts:	$201,109

Note: There were zero contracts awarded without SF1411.

The second exception that the auditor took was with the exclusion of both current and deferred profit sharing costs from the break-even analysis. The auditor felt that these costs were generated by the cafeteria department and should be treated exactly the same as other salaries and wages. They should have been included as an unallowable portion of

cafeteria costs when calculating an adjusted labor overhead rate.

The third exception that the auditor took with AEC's cost impact proposal was the seven percent per annum interest rate used. The interest rate should have been the Treasury rate in affect at the time, which was above seven percent.

Using the same basic methodology as AEC, the auditor recomputed the cost impact taking into consideration his exceptions concerning the profit sharing costs and the interest rate. The auditor accepted the list of contracts provided by AEC as complete. The auditor's cost impact totaled $390,054 as compared to the AEC total of $289,628, however, with the auditor's recommendation, the ACO decided to negotiate the difference.

Negotiations between the Government and AEC were conducted on 7 May 1990. The Government was represented by the ACO and a DCAA auditor. AEC was represented by the Supervisor of Pricing and Cost Analysis, and the Supervisor of Government Accounting. During the negotiations the following points were clarified/agreed on:

1. AEC confirmed that the practice of charging cafeteria costs below the break-even point was corrected 1 January 1987.

2. AEC confirmed that the listing of contracts used to compute the cost impact was complete. The ACO also requested and AEC agreed to certify that the listing is

complete to the best of their knowledge, and if other affected contracts were discovered in the future, AEC would agree to re-open negotiations and reimburse the Government for overcharges at that time.

3. It was agreed that an offset of other open contracts would be the vehicle for recovery, and a Letter of Agreement would be executed which would include the certification discussed above.

4. The interest charge agreed on totaled $66,772, computed as follows:

   a. The midpoint of contract shipments over the life of each affected contract would be used as the starting point for interest calculations and interest would accrue up to the time the adjustment is affected, 1 June 1990.

   b. Prior to August 1986, the Cost Accounting Standards clause stated that the interest rate would be the Treasury rate or seven percent, whichever was less. FAC 84-21 dated 29 August 1986, eliminated the seven percent cap on interest. During the negotiations it was agreed that for all 1985 and 1986 contracts, seven percent would be used (the actual Treasury rate was one to one and a half percent higher for these years), and for all 1987 contracts, the actual Treasury rate would be used.

5. The final point to clarify was the profit sharing costs. It was noted by AEC that depreciation and property tax had been excluded from the cafeteria costs because these costs would exist even if there were no cafeteria. AEC's position was that the profit sharing costs should be excluded on the same basis because if the profit sharing had not gone to cafeteria workers, it would have gone to others in the company. It was the auditor's position on the other hand that profit sharing is a benefit that amounts to approximately 35 percent of each worker's compensation, and should be considered the same as salary costs. The final cost impact negotiated (excluding interest) was $304,228. It represented a compromise between AEC's initial position which completely excluded the profit sharing costs, and the DCAA audit report which included all profit sharing costs for cafeteria workers.

When negotiations were completed, the total cost impact agreed to by both parties was $371,000, summarized as follows:

Negotiated Cost Impact	$304,228
Interest	66,772
Total Cost Impact	$371,000

E. SUMMARY

CAS 405 does not actually identify costs which are unallowable on Government contracts. CAS 405 deals with the accounting and separate identification of allowable vs unallowable costs. It requires that any expressly unallowable cost must be identified and excluded from any billing, claim, or proposal applicable to a Government contract. There is no doubt that in this case the cafeteria costs in question were unallowable. The Cost Principles (FAR Subpart 31.205-13(b)) specifically state that costs associated with a food service operation which is not operated with the intent of breaking even are unallowable. AEC´s cafeteria was obviously being operated with the intention that the company would subsidize the meal cost for employees, a fact that AEC openly admitted to in the beginning.

AEC knew from the outset that according to the letter of the law these cafeteria costs were unallowable and should have been excluded from all CAS covered contracts and subcontracts.

However, that did not stop them from putting up a defense and attempting to mitigate the cost impact as much as possible. It took over three years for the two sides to agree on a fair settlement.

AEC´s first response to the Government regarding the allegations consisted entirely of an attempt to reason with the ACO. AEC tried to convince the ACO that since the company pays its employees less than standard wages and makes up for it with above average benefits, such as the cafeteria, that these costs should be considered additional wages. The letter went on to explain in detail the multitude of benefits, including increased productivity and morale, that accrue to the company and its customers (i.e., the Government) as a result of operating the cafeteria in this manner. Additionally, AEC was very concerned how its commercial customers would react to the Government´s decision to disallow these costs.

It could be argued that there is some validity to this defense on the part of AEC. They do pay their employees less than standard industry wages and make up for it with a very attractive package of benefits. It definitely penalizes the company and its employees if these costs cannot be recouped through normal operations. However rational the argument may be, the bottom line for DCAA and thus for the ACO is that the

costs are explicitly unallowable and subject to reimbursement by the company. This is the position that they would maintain.

AEC's second response to the allegations was similarly fruitless, but did result in the Government acknowledging that the non-compliant practice was corrected as of 1 January 1987. However, each time DCAA audited one of AEC's rebuttals, the auditor found a way to increase the estimated cost impact. By the time AEC finally decided that their only choice would be to try and mitigate the cost impact and they submitted their first cost impact statement, the ensuing audit resulted in a difference of $1,352,300 between AEC and the Government. It was certainly obvious that AEC had understated significantly the cost impact, and DCAA presented the absolute worst scenario for AEC. This did motivate AEC to come up with an acceptable list of affected contracts and subcontracts, and submit a more realistic cost impact statement. From this, the two sides were able to negotiate a settlement.

While the interpretation of CAS 405 in this case was fairly easy, implementation turned out to be extremely difficult and time consuming. Issues concerning which contracts and subcontracts to include, and which costs involved in the operation of the cafeteria had to be resolved before an agreement could be reached. With each side trying

to game the other, this only made for a more difficult resolution.

Earlier face to face discussions between the parties could have saved much time and energy on both sides, and possibly resulted in a much sooner resolution. However, this is not always in the best interests of the company, who is trying to prevent the repayment of any costs to the Government by stretching out to the maximum extent possible the implementation of the regulation.

V. CASE 3: COST ACCOUNTING STANDARD 418

A. INTRODUCTION

The purpose of this chapter is to present the third Cost Accounting Standard non-compliance case involving American Electronics Corporation (AEC). This case involves Cost Accounting Standard 418, Allocation of Direct and Indirect Costs. The facts of the case will be presented in detail from the time the initial finding was first reported until the company became compliant with CAS 418. This will then be followed by a summary and analysis of the issues in this case.

B. INITIAL FINDING OF NON-COMPLIANCE

On 22 December 1981, DCAA conducted an audit of proposed costs that AEC had submitted in their bid for a subcontract. During the audit the DCAA auditor conducted a routine evaluation to determine if AEC was in compliance with the CASB's rules, regulations and standards. The results of the audit concluded that AEC was in potential non-compliance with CAS 418. Further, that AEC had a CAS 418 applicability date of 1 January 1982. This was formally reported to the ACO by letter on 29 March 1982. According to the auditor's findings, by the time this report was submitted the company was actually

in non-compliance. Their actual applicability date was later determined to be 1 October 1982, as will be discussed in detail later in the case.

The auditor found that AEC's stated accounting practice was to include all engineering costs in the G&A expense pool. Further, that some of AEC's engineering activities, such as technical and non-supervisory labor, were performed directly for cost objectives and could be identified as such in the records. This is contrary to CAS 418 which requires that all costs identifiable to a specific objective be charged directly to that objective, and costs not directly assignable be accumulated in homogeneous cost pools.

The auditor concluded that in order for AEC to comply with CAS 418, they must restructure their overhead rates by adjusting the G&A expense rate and adding a rate for indirect engineering expense. The reason for this change is that the indirect engineering costs were material in amount, and so in accordance with CAS 418 should be grouped in a separate cost pool and allocated to cost objectives based on some causal relationship. In this case that would be direct engineering labor. For FY 1982, the auditor developed estimates for this rate restructuring as shown in Exhibit 5-1.

The G&A rate would decline by 14.2 percent as a result of decreasing the G&A expense pool by $6,655,000 (the amount

Exhibit 5-1

DCAA AUDITOR DEVELOPED RATE RESTRUCTURING

	G&A Rate - Present Condition	FY82 Forecast
(A)	Total G&A Expenses (including total engineering costs)	$11,518,000
(B)	Total Factory Cost Input Base	$50,618,000
(C)	G&A Expense Rate (A/B)	22.7%
	G&A Rate - Audit Determined	
	Total G&A Expenses	$11,518,000
	Less: Engineering Costs	6,655,000
(D)	Adjusted G&A Expense Pool	$4,863,000
	Total Factory Cost Input Base	$50,618,000
	Add: Engineering Costs	6,655,000
(E)	Adjusted Factory Cost Input Base	$57,273,000
(F)	G&A Expense Rate (D/E)	8.5%
(G)	Rate Difference Questioned (C-F)	14.2%
	Eng Expense Rate - Audit Determined	
(H)	Direct Engineering Labor Base	$1,536,000
(I)	Engineering Expense Pool	$5,119,000
	Engineering Expense Rate (I/H)	333.27%

of engineering expense included in the pool), and increasing the cost input base by this same amount. The engineering expense rate, based on direct engineering labor dollars, was developed by taking the indirect portion of the engineering expenses, which would make up the engineering expense pool,

and dividing it by the direct portion of engineering labor. The result is a new engineering expense overhead rate of 333.27 percent of direct engineering labor expense. The auditor concluded from this that the estimated annual cost impact on DOD contracts could be in excess of $400,000 of additional costs to DOD, but did not include any explanation or documentation to support this figure. On 5 April 1982, the ACO provided a copy of the audit report to AEC and requested comments be provided on the findings. AEC responded on 16 April 1982 in complete disagreement with the auditor´s findings. In referring to the audit report, AEC commented:

> The report states: "The subcontractor´s accounting practice for engineering costs is to charge all engineering costs as indirect in the G&A pool." This statement is incorrect and does not reflect AEC accounting practices. The AEC Accounting Manual states (Ch.VIII, P.1): "Research and Development costs identifiable to a particular product or activity are accounted for under the project accounting system. Each individual project is assigned a project number which attaches to a specific number and order." The manual enumerates specific types of data which are accumulated for each project, including direct labor, parts transferred, purchased items, subcontract work, and tooling. Thus, costs which can be identified to specific cost objectives are charged direct. Costs not identifiable are accumulated in the engineering pool. Clearly, this is consistent with practices required by CAS 418.

AEC is attempting to equate research and development costs with engineering costs in order to show that they do have a written policy for the allocation of engineering costs and

that it isn't their policy to charge it all to G&A. However, all R&D costs cannot be classified as engineering and all engineering costs are not considered R&D. Therefore the argument was weak and unfounded, but it was the closest thing to a written policy that AEC had.

AEC's response was forwarded by the ACO to DCAA for review. On 29 July 1982, DCAA provided to the ACO comments regarding AEC's position. DCAA maintained that AEC has the capability to account for direct engineering labor and engineering overhead costs and therefore is required to maintain a separate engineering overhead pool and a base of direct engineering labor which is representative of the activity being supervised.

The DCAA letter went on to describe four conditions that existed in AEC's accounting practices which would have an impact on the CAS 418 non-compliance. Those conditions were:

> 1. The contractor has not defined when engineering costs will be charged direct or indirect in accordance with CAS 418 requirements. The contractor records engineering costs direct to final cost objectives as well as indirectly to G&A expenses. The contractor has no written policies that substantiate what their criteria are for charging engineering costs direct or indirect to a final cost objective.
>
> 2. The contractor arbitrarily allocates 50 percent of engineering direct charges to cost of sales when a project is authorized. The remaining expenses are classified as unabsorbed project burden and are added to the engineering overhead expense pool. The unabsorbed account may or may

not be charged back to those engineering direct project charges upon contract completion.

3. The contractor maintains an overhead pool identified by engineering department for those charges of supervision, indirect labor, profit sharing, member benefit expense, occupancy and other associated engineering related costs.

4. A material amount of the costs included in the indirect cost pool are costs of management or supervision of engineers. Therefore, an allocation base of direct engineering labor must be used for the engineering activity being managed (per CAS 418-40.(c)(1)).

As before, the auditor concluded that in order for AEC to comply with the requirements of CAS 418, they must establish a properly prepared engineering overhead pool and a direct engineering labor base. The auditor also recommended to the ACO that AEC prepare and submit a cost impact proposal for all CAS covered contracts and subcontracts that would be affected by this change.

The ACO concurred with the auditor´s conclusions, and on 9 August 1982 sent a letter to AEC explaining the Government´s position. In short, the ACO recommended that AEC establish an engineering overhead pool and a direct engineering labor base in order to comply with CAS 418, and further requested a cost impact proposal be submitted as a result of the CAS non-compliance.

C. DISPUTING THE CASE

After several months delay, attributed to consultation with outside accounting assistance, AEC responded on 17 February 1983. The letter began with the following statement which summed up their position:

> We do not believe the recommended changes are in the best interests of the U.S. Government or AEC. The Government would have to pay an additional $1.54 million for contracts which have been negotiated to date, plus an indeterminable but much larger amount for future contracts. AEC would have to make changes to accounting systems which would increase administrative costs for all customers.

The cost impact of $1.54 million was arrived at by developing a new overhead rate structure as recommended by the DCAA auditor. AEC developed an engineering overhead rate by combining engineering department labor from direct and indirect costs, and divided this total into the amount representing engineering support costs, which were removed from G&A. This resulted in the following rate changes:

	Overhead Base	Current Rates	Restructured Rates
Material Overhead	Dir Matl	17.1%	17.1%
Labor Overhead	Dir Labor	496.1%	593.3%
Engineering Overhead	Dir Eng Labor	----	183.5%
G & A	Total Cost	23.1%	18.7%

AEC identified eleven contracts which would have been affected by the change in overhead rates. These were all

contracts which had been finalized after 20 September 1980 through to present CAS-covered contracts in-house as of February 1983. The new rates were multiplied by the estimated cost inputs for the affected contracts, and the percentage change in total cost was applied to the final negotiated prices. The result, in each and every case, was a price increase the sum of which totaled $1,542,698.

It is interesting to note that AEC was not arguing that they were in compliance with CAS 418, but rather were attempting to make a case that complying with the exact letter of CAS 418 in this circumstance would be detrimental to the Government. The real driving force behind their position however was not the interests of the Government, but rather the resources that AEC would have to expend in order to make the necessary changes to its accounting systems. AEC´s official position as stated in its letter was:

> AEC prefers to leave present accounting practices and procedures unchanged inasmuch as the suggested changes would entail additional costs for both the company and the Government, with little advantage to either, excepting stricter compliance to the letter of CAS 418. We respectfully suggest that it is to our mutual advantage to resolve this matter in a manner which will be the least costly to both parties. Therefore, we suggest the following course of action:
>
> 1. AEC will amend its Accounting Manual to clarify policies and practices for classifying costs as direct or indirect; and

2. AEC will continue to develop and propose rates which are consistent with present accounting systems.

The subsequent DCAA audit, dated 5 April 1983, of AEC's cost impact proposal focused on two issues. First, was the methodology used by AEC in developing the restructured rates. Second, and more importantly was the actual applicability date of CAS 418 for AEC.

AEC's proposed rates were based on FY 1981 actual cost data. The DCAA auditor preferred to use FY 1983 budgetary data (FY 1982 actuals were not available and he wanted the most current and accurate cost data) adjusted for unallowables and escalation of labor bases consistent with prior years. The restructured rates as proposed by AEC and as determined by the auditor are summarized below:

	AEC Proposed Rates	Audit Determined Rates
Material Overhead	17.1%	17.1%
Labor Overhead	593.3%	585.0%
Engineering Overhead	183.5%	162.0%
G & A	18.7%	14.0%

However, the auditor considered any cost impact at this point to be a moot point because of the applicability date of CAS 418 for AEC. AEC's proposed cost impact was based on contracts received after the effective date of CAS 418 which was 20 September 1980. Their applicability date for CAS 418 was 1 October 1982, which was determined as the second fiscal

year after receipt of a trigger contract (first CAS covered contract awarded after effective date of new standard), which was received on 28 October 1980. The distinction here is between the effective and applicability dates for a Cost Accounting Standard. According to DOD Working Group Item 76-7, the effective date of a standard designates the point in time when the pricing of all future CAS-covered procurements must reflect the requirements of the newly promulgated standard; and identifies those existing contracts eligible for an equitable adjustment to reflect the cost impact of applying, prospectively, the provisions of the new standard. The applicability date marks the beginning of the period when the contractor must actually change the accounting and reporting systems to conform to the standard [Ref. 12: p. 89-90]. AEC's fiscal year ends on 30 September, hence their applicability date for changing their records would be 1 October 1982.

In his audit report, the DCAA auditor concluded:

> Since the contractor has not received a contract after the applicability date, CAS 418 is not applicable. Therefore, the proposed cost increase is not applicable and should be disallowed. Notwithstanding the fact that the contractor is still in potential non-compliance, rather than actual non-compliance, nor that cost impact need not be calculated, we are of the opinion that the contractor adhere to the provisions of CAS 418 beginning fiscal year 1 October 1983. At that time, cost impact may be relatively minor, irregardless, there would be positive benefits to the Government in the event engineering effort

> in contracts is significant, or if engineering contracts are received in the future. We further believe that CAS 418 should be adhered to by all contractors who are subject to it regardless of its significance in impact. The contractor should be required to submit a cost impact statement that shows the impact on these contracts when the standard becomes effective.

On 26 April 1983, the ACO informed AEC by letter of the Government's position. Specifically, that they must adhere to the provisions of CAS 418 beginning on 1 October 1983, and at that time a cost impact statement covering all active Government contracts in-house be submitted.

However, the DCAA auditor had made a mistake in the audit report, and submitted an amended audit report on 15 June 1983. The mistake involved the applicability date, which the auditor originally determined to be 1 October 1983. Actually, it was 1 October 1982. The auditor corrected his mistake and now concluded that since AEC had not prepared a cost impact statement within 60 days of the fiscal year beginning 1 October 1982, no increased costs were allowable on its Government contracts. This 60 day requirement is contained in the Cost Accounting Standards Clause and FAR 52.230-4. AEC's cost impact statement was submitted on 17 February 1983, four and one-half months after the 1 October 1982 applicability date.

On 24 June 1983, the ACO sent AEC another letter rescinding the 26 April letter, and informing AEC of the

Government's new position. First, that AEC was now in non-compliance with the requirements of CAS 418 and any increased costs paid by the Government can and will be recovered with interest. Second, that AEC would not be allowed to recover additional costs on current contracts as a result of compliance with CAS 418, because they did not file a timely cost impact statement. Finally, the ACO requested that within 30 days, AEC agree or submit reasons why existing practices were in compliance.

AEC's response, dated 28 July 1983, was short (only one page), and focused on the negative effect that implementation of the proposed accounting change would have on contract costs to the Government. In their response they state:

> Developing and proposing a separate engineering rate would increase the cost of virtually all CAS-covered contracts. This was the conclusion of the DCAA review of our cost impact statement. Our intention in preparing the statement was not to recover additional amounts from the Government, but to demonstrate the added cost for future contracts if we were forced to comply. AEC prefers to leave present accounting practices and procedures unchanged, inasmuch as the suggested changes would:
>
> 1. Entail additional costs for both the company and the Government, with little advantage to either; and
>
> 2. Force us to treat the Government differently than our commercial customers who account for about three-quarters of total billings.

In order to support their claim that these additional costs were reason enough to leave present accounting practices

unchanged, AEC cited a paragraph from the Federal Procurement Regulations relating to changes in cost accounting practices, which states:

> Prior to the use of the equitable adjustment provisions of the Cost Accounting Standards clause, the cognizant contracting officer (ACO) shall make a finding that the change is desirable and is not detrimental to the interests of the Government.

Their argument is not based on the issue of compliance, but rather they are appealing to the ACO to use what they perceive as the ACO's prerogative to make a determination that forcing this change would be detrimental to the interests of the Government. This in turn would lead the ACO to allow AEC to maintain their current accounting practices.

This would be the last official correspondence between the ACO and AEC relating to this issue for three years and eight months. There is no indication in the official records why the ACO at the time did not continue to follow-up on the non-compliance. Since the ACO position changed hands twice between July 1983 and March 1988, and once again in August 1989 (when the current ACO took over), it was impossible to determine the exact reasons for the inaction.

Strictly from a speculative standpoint, there are indications that the ACO didn't want to make a decision on this issue. In January 1984, the ACO received a letter from

the Procuring Contracting Officer (PCO) of one of the largest Government programs that AEC was involved in. The letter expressed concerns that correcting AEC's accounting practice may increase contract costs by several million dollars. This cost increase would heavily impact budget and funding considerations for the program.

On the other hand, DCAA had determined that AEC was in non-compliance with CAS 418 and should change their accounting practice. The ACO may have found himself in a no win situation. Thus, no action was the best action. If he had officially determined that the change in accounting practice was not necessary, then he had to be prepared to justify his decision in view of the DCAA audit report. On the other hand, if he mandated AEC change its accounting practice, he may have been asked to justify his decision in view of the increased costs and possible disruption of ongoing programs.

D. RESOLUTION

On 3 March 1988, the Government officially resurrected the CAS 418 non-compliance case. At this time AEC had several CAS issues pending, including an updated disclosure statement and non-compliance cases on CAS 401, 402, 405 and 418. In an attempt to resolve all these CAS issues, the ACO sent a letter to AEC requesting an updated disclosure statement and cost

impact statements for the various CAS non-compliances. AEC responded by letter requesting an extension on the CAS 418 case until 10 June 1988, which was granted.

AEC's response, which was not submitted until 22 August 1988, was almost identical to the cost impact statement that had been submitted on 17 February 1983. The only difference was that they used actual FY 1987 data to restructure the overhead rates. However, the results and the conclusions were the same. The restructured rates resulted in a net price increase to the Government in the amount of $1,555,064. This included all open contracts currently being shipped against and open orders not yet negotiated.

AEC's conclusion, as before, was that the cost increase was certainly detrimental to the interests of the Government and so compliance with CAS 418 should not be mandated. They requested however, that if the ACO determined that the change in accounting practice be made, they be granted a grace period of three years in order to implement the necessary accounting systems changes that would be required.

The DCAA audit that followed, dated 30 January 1989, was in agreement that the Government had not paid any increased costs as a result of the CAS 418 non-compliance. Further, the auditor agreed that compliance would have resulted in higher contract costs to the Government, although to a less

significant degree than AEC had determined. The audit report did not include the calculations to support this conclusion. Nevertheless, the two sides agreed that compliance with CAS 418 would more than likely result in the Government paying more on future contracts.

The real issue for DCAA was not the increased costs, but rather the inadequacy of AEC´s present accounting practices. In the audit report the auditor brings up the following points which highlight the need for compliance with CAS 418:

1. The contractor has not defined when costs will be charged direct or indirect in accordance with the requirement of CAS 418.40(a), which states that , "A business unit shall have a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied." The contractor has not defined when, for example, engineering costs will be charged direct or indirect. The contractor records engineering costs direct to final cost objectives as well as indirectly to General and Administrative expenses. The contractor has no written policies that substantiate what the criteria is for charging engineering costs direct or indirect. We noted that the contractor is on record as stating in a 17 February 1983 letter to the cognizant ACO that: "AEC will amend its Accounting Manual to clarify policies and procedures for classifying costs as direct or indirect." To date, the contractor has not performed this step and has previously stated that their Accounting Manual is out of date.

2. A material amount of the cost included in the indirect cost G&A pool are costs of management or supervision of engineers. Additional costs identified by engineering department include: indirect labor, profit sharing, member benefit expense, occupancy, and other associated related costs. CAS 418.40(c)(1, 2, and 3) provides that, "pooled costs shall be allocated in reasonable proportion to cost objectives based on the beneficial or causal relationship of the pooled costs to cost objectives." Therefore, we are of

the opinion that AEC has contravened these provisions of CAS 418 by including engineering on proposals through the application of a combined Engineering/General and Administrative expense rate.

3. The contractor has requested a grace period of three years in order to implement the changes necessary for compliance with CAS 418. It is the contractor's position that the accounting changes required for compliance with CAS 418 are detrimental to the interests of the Government. Thus, the contractor asserts that the additional time requested to implement the accounting changes will not result in any increase in costs paid by the Government. However, the contractor has not provided details of management's action plan demonstrating the how, what, when and so forth as to the implementation of the necessary changes. Nor has the contractor specified how the progress should be monitored on a continual basis to ensure that the non-compliant condition does not reverse itself and result in increased costs paid by the Government.

The ACO concurred with the conclusions contained in the audit report. On 14 April 1989, the ACO sent a letter to AEC requesting three things. First, the disclosure statement be revised to include criteria for charging engineering direct or indirect. Second, a detailed description of the necessary changes required for accounting practices to be compliant. Third, how and when these changes would be effected and monitored for compliance. In conclusion, the ACO stated:

> It is determined your compliance with CAS 418 will not be detrimental to the Government and that the changes required will not significantly increase contract prices to the Government. Additionally, FAR 30.306, in support of FAR 52.230-3 and 5, states the U.S. will not pay increased costs by reason of a contractor's failure to use applicable cost accounting standards.

AEC submitted two responses to this request by the ACO. The first response, dated 2 June 1989, was brief and attempted to explain in general terms what the changes in accounting practices would enable the company to do. Specifically, the letter stated:

> This project will enable AEC to record costs, by type, so that engineering rates can be determined. This will also allow us to separate engineering expenses from G&A costs. However, the changes needed are extensive and have not been all specified at this time. In early June, necessary program changes will be determined and we will be able to provide a preliminary schedule for implementation and a detailed description of the changes required.

The second response, dated 23 June 1989, was more specific as to the changes being made and the difficulties in achieving these changes in a short period of time. In this response AEC highlighted the following points about what they termed as their new project cost system:

1. The ability to improve project management capabilities.

2. To allow costs for any type of project to be accumulated. The current system has a limited definition of project costs. However, under the proposed system, we will distinguish between different types of projects such as: independent development, contract development, basic research, product support, retrofit business, B&P, capital projects, technical billings, and any other type of activity that requires a cost accumulation system.

3. The ability to accumulate costs of activities while still recording the proper general ledger transactions. Project cost information will identify the general ledger account charged allowing the project costs to be accumulated by account number, which will facilitate compliance. The

programming effort for this basic requirement will be the most difficult and time consuming to implement.

4. The ability to post costs automatically from the different input systems. Currently, none of the costs post automatically and are not posted until after the end of the month. This delays information feedback to users.

5. Project reports that better fit the needs of the user.

AEC admitted in their letter that they were at the beginning of the planning process to achieve these changes. Further, they stated that it would take six months to gather the necessary information and lay out a timetable for completion of the project.

On 3 July 1989, the ACO responded by letter in agreement that the proposed changes would have an effect on the CAS 418 non-compliance, and requested a more definite timetable for implementation. AEC provided an interim reply on 3 November 1989, which didn't provide additional information. Finally, on 28 February 1990 they provided more definitive plans.

AEC informed the ACO that they had completed two important actions towards completion of the project. Specifically, the program specifications had been identified and the project had been assigned to a programmer. Additionally, they stated that four steps were remaining to completion. Those steps were:

1. Program requests needed to be developed.

2. Program requests needed to be approved by those affected.

3. Actual programming.

4. Implementation of the program.

AEC had set an initial implementation date of 1 October 1990.

The ACO concurred with the implementation date, and requested that AEC provide updated status as the project progressed. Due to programming problems the implementation date slipped twice. However, on 1 January 1991, the new cost system was fully implemented. Nine years after DCAA had found AEC to be in non-compliance with CAS 418, the company implemented the changes necessary to comply with the standard.

E. SUMMARY

This case brings to light two important issues with regard to the Cost Accounting Standards. The first issue concerns the implementation of a new Cost Accounting Standard, and the second issue deals with whether the Government is justified in implementing a standard if the end result will mean increased prices for the Government.

This case is a classic example of the problems inherent in the implementation of a new Cost Accounting Standard. It took over nine years to get AEC to comply with the requirements of CAS 418, and the case is still not officially closed because the ACO is currently waiting for AEC to submit a cost impact statement as a result of the change in accounting practice.

This delay in resolution was not caused by a disputed interpretation of CAS 418, but rather, was the result of confusion and indecision on the part of Government personnel trying to implement a new Cost Accounting Standard.

In the initial audit report submitted by DCAA, the auditor determined that AEC's applicability date for CAS 418 was 1 January 1982. This meant that by the time the ACO received the report, AEC was past the applicability date and was then considered to be in non-compliance with CAS 418. If the auditor had correctly determined the applicability date as 1 October 1982, AEC could possibly have made the necessary adjustments to their accounting system prior to the deadline. However, believing that they were already in a non-compliant situation, AEC opted to try and refute the allegations. The actual applicability date wasn't correctly determined until two and one-half years after the initial finding.

There was also confusion on the method and timing for determining the cost impact. In the initial audit report, the auditor used FY 1982 data in order to restructure the overhead rates. However, since the applicability date wasn't until FY 1983, those calculations were misleading and meaningless. It is also interesting to note that the auditor alleged over-pricing in excess of $400,000 on DOD contracts as a result of the non-compliance. This was the only time that this

conclusion was ever reached by either a DCAA auditor or AEC. The auditor provided no data to substantiate this finding, and so it can only be assumed that this was the conclusion of an over zealous auditor determined to find questioned costs.

When AEC submitted its first cost impact statement, there was no real guidance given by the ACO as to the method and timing that should be used. AEC assumed that the cost impact should be determined prospectively from the date the standard became effective, on 20 September 1980. They also did not realize that the cost impact statement needed to be submitted within 60 days after the applicability date. At the time though, they weren´t interested in actually collecting additional costs on contracts in order to comply with CAS 418. Their main interest was to convince the ACO that the cost impact of compliance was detrimental to the Government, in the hope that the ACO would not mandate the change in accounting practice.

If AEC had been advised from the beginning that their applicability date was 1 October 1982, and that they had 60 days from that date to submit a cost impact statement, prospectively from that date, resolution could have been quicker and easier. However, it wasn´t until mid 1983 that the actual applicability date was determined, and a proper cost impact statement is yet to be submitted.

The implementation of a new Cost Accounting Standard definitely presents unique difficulties for which the ACO and the company were unprepared. The effective and applicable dates must be determined and distinguished from the outset. The cost impact of any required change in accounting practice must be determined from the appropriate date and calculated prospectively. Also, the ACO must be prepared to analyze the change in accounting practice to determine if it goes beyond the scope of that required to comply with the standard. This must be accomplished in a timely manner in order to determine the appropriate equitable adjustment to be made. Consideration also must be given to the possible funding impact on current contracts and thus to ongoing programs. All of this must be carefully analyzed and coordinated in order to bring an expeditious conclusion to a CAS non-compliance resulting from a new standard.

The second issue that this case raises is whether or not a standard should be implemented if it increases costs to the Government. In this case, DCAA and eventually the ACO agreed that it was essential for the Government to implement CAS 418.

The fact that the change in accounting practice will adversely affect contract pricing for the Government makes the situation difficult. A conflict of interest arises between DCAA, the company, and the Contract Administration Office's

customer activities. DCAA wants to follow the letter of the law, the company doesn´t want to expend resources to make changes in its accounting practices, and customer activities advocate maintaining the status quo so as not to upset their ongoing programs.

In this case the argument posed by AEC that increased costs are detrimental to the Government is unfounded. While it is true that the Government may end up paying more because of the change, this is because the change in accounting practice will provide more accurate allocation of costs to cost objectives. Direct and indirect engineering costs will be more accurately allocated to all contracts, and those that use the engineering services will pay their fair share. Thus, there really aren´t any additional costs, but rather a redistribution of the costs more equitably between contracts.

From an auditing standpoint, the accounting practice being employed by AEC with regard to engineering costs was open to a great deal of inconsistency. They had no real definite policy for allocating engineering costs direct or indirect, and misallocated much of these costs to G&A. With the implementation of CAS 418, the allocation of these costs as direct or indirect becomes written policy, direct engineering costs will be allocated to the proper cost objective, and

indirect costs will be accumulated and allocated based on a more causal relationship.

The primary goal of the Cost Accounting Standards Board was to bring uniformity and consistency to the cost accounting practices followed by industry. It was recognized that at times this may result in increased costs on certain Government contracts, however, on the whole the benefits of change would outweigh the costs. The difficulty lies in convincing industry to expend the resources to make the necessary changes, and educating Government personnel on the accounting issues involved.

VI. CONCLUSIONS AND RECOMMENDATIONS

A. INTRODUCTION

The purpose of this chapter is to present the researcher's conclusions and recommendations from this research project. Each of the three CAS cases examined contained significant differences between the Government and the company in the interpretation and implementation of the Cost Accounting Standards involved. While the facts are unique to these cases, the reasons for these differences and the solutions to them can be applied throughout the defense industry. After evaluating these three cases, the researcher has developed the following conclusions and recommendations.

B. CONCLUSIONS

Conclusion #1. The Administrative Contracting Officer (ACO) does not have a full understanding of the issues involved in interpreting and implementing the Cost Accounting Standards. The ACO is the key person in the Contract Administration Organization for ensuring that CAS issues are pursued and resolved fairly and expeditiously. The most recent ACO involved in the cases presented in this research project had no formal CAS training, and no previous experience

dealing with accounting issues. This is probably common throughout the ACO community.

The ACO must make the determination of non-compliance, enforce the implementation of the Standards and negotiate an equitable cost impact. However, as can be seen from the three case studies presented in this research, the ACO is hesitant to make decisions on CAS issues and relies completely on DCAA input. The ACO must have the ability to analyze and interpret both contractor and DCAA positions in order to make informed decisions and develop a realistic negotiation position. As it stands, the ACO always takes the DCAA position (right or wrong), which causes additional friction between the contractor and the Government, causes inordinate delays in resolution of the issues and increases the costs of implementation for both Government and Industry.

Conclusion #2. Companies such as American Electronics Corporation will continue to have problems adhering to the Cost Accounting Standards. A company that has a significant interest in both commercial and Government applications of its products has tremendous difficulty maintaining two separate and distinct types of accounting systems. The Cost Accounting Standards impose rigid requirements for the estimating, accumulating, reporting, and allocating of costs that generally are not followed in the commercial environment.

Smaller companies are not staffed or trained to handle these additional requirements, and won´t know of their existence until that first instance of non-compliance. AEC was not prepared to handle all the problems associated with the implementation of the Cost Accounting Standards, and had no one internally available that was sufficiently knowledgeable to assist them. The company was eventually forced to hire three individuals to handle only Government accounting issues, and these individuals admitted that their knowledge came largely from on-the-job experiences over the years. This coupled with the need for outside accounting assistance results in a significant cost impact to the company to adhere to the Standards. AEC is representative of a large group of defense contractors and subcontractors that will prefer to maintain commercial accounting practices, even at the expense of diminishing Government business. While these companies represent a small percentage of total Government contracted dollars, they do represent a large percentage of Government contractors and subcontractors.

Conclusion #3. The Government, especially DCAA, is more concerned about cost impact and recovery than ensuring the expeditious compliance with the Cost Accounting Standards. The first case presented, involving CAS 401 and 402, is a perfect example of this. In this case the claimed costs were

disallowed because AEC used judgement instead of more detailed and substantiated accounting methods. However, it was shown by AEC and confirmed by DCAA that if AEC had complied with CAS 401 and 402 as directed by DCAA, costs actually would have been higher for the Government. Nevertheless, the cost impact issue was pursued vigorously with little concern for actual compliance. The Government policy of figuring out cost impact based on what would have been negotiated if the non-compliant practice is eliminated but not corrected leaves the contractor with little ground to stand on.

Compliance should be the overriding issue in all cases. This is not to say that cost impact is unimportant, but to gain the support and cooperation of the contractor, especially in a circumstance where the cost is valid and fraud is not present, the Government should concentrate its efforts on the expeditious resolution of the non-compliant practice.

Conclusion #4. The rules regarding the implementation of a new Cost Accounting Standard are too complex. Under the current procedures, the ACO must deal with multiple issues relating to the implementation of a new standard and its effect on a firm. The ACO must be able to distinguish between the effective and applicability dates of the standard for the contractor and ensure the contractor understands the significance of these dates. Further, the ACO in conjunction

with DCAA must be able to determine the effects of the new standard on the CAS-contract universe and whether the contractor's proposal to comply includes only the mandatory changes.

The issues of the CAS-contract universe and the cost impact are especially difficult because of the fact that the new standard will impact retroactively on only the new performance of old contracts. This means that only that portion of an old contract not yet performed as of the effective date of the standard will be included. This is obviously a difficult concept to comprehend and apply. The reason for this procedure was to preclude the contractor from having to maintain different accounting systems for different contracts. However, as can be seen in the third case presented in this study, the ACO is unprepared and under staffed to deal with all these issues and be able to accurately assess the contractor's position. DCAA is there to assist in these efforts, however, the ACO cannot and should not rely 100 percent on DCAA input. As evidenced from the case, this input can be erroneous. With the recent reformation of the CASB and imminent promulgation of new standards, this issue will become increasingly important.

Conclusion #5. Determining the cost impact of a CAS non-compliance is the single most difficult and time consuming

element in resolving a CAS conflict. In the three cases presented in this research, interpretation of the Cost Accounting Standards involved was not the major problem. Within a reasonable period of time the auditor and the contractor were able to come to agreement as to the non-compliant practice.

In cases where interpretation is the overriding issue, the contractor will generally dispute the ACO´s determination and appeal the case to some other authority (BCA, Court, GAO). This was seen in the cases reviewed in Chapter II. Even in these circumstances the ACO may still be left to settle the cost impact issue. Determining the true exact cost impact is perhaps an impossible task. Differing interpretations over the contract universe to include, time periods involved, and accounting methods to employ, make it extremely difficult for the two sides to come to an agreement. Above all else, the ultimate goal of each is in complete contrast. The contractor seeks to absolutely minimize the cost impact and may conveniently leave out affected contracts. DCAA in reaction to this looks to maximize cost impact and often paints a worst case scenario. The differing positions, as evidenced in the three cases, can at times be incredulous. Often too far apart to even begin discussing a settlement.

Conclusion #6. The current process of resolving non-compliance with the Cost Accounting Standards fosters an adversarial relationship between Government and Industry. From the beginning to the end of the process each side has an "us against them" attitude, where one side will win and one will lose. This is evidenced in all three cases presented in this research. In each, the contractor´s cost impact proposals and Government audits were completed in isolation of the other side and without each party completely understanding exactly what is going on. This puts both the contractor and the DCAA auditor on the defensive, both trying to convince the ACO that their widely conflicting positions are correct. However, the ACO doesn´t have the time or a complete understanding of the accounting issues involved to determine an equitable compromise. It takes months to prepare a well documented cost impact proposal and an equally long period of time to conduct a thorough audit of the proposal. The current process only generates years of proposals and audits, mounds of paperwork for the ACO to wade through and ill feelings on both sides. The eventual resolution is more a result of Governmental sovereignty than of mutual cooperation and agreement.

C. RECOMMENDATIONS

Recommendation #1. The ACO should be given adequate training in the area of cost accounting and the Cost Accounting Standards. Before the ACO can begin to understand CAS issues, he/she must acquire a general understanding of cost accounting principles and the types of cost accounting systems used in industry. Basic cost accounting courses are taught in just about every college and university in this country, and should be a prerequisite for becoming an ACO. Once this basic knowledge of cost accounting is acquired, then the ACO must be given more indepth training on the Cost Accounting Standards. Training could be given on an informal basis by local DCAA auditors, or in a more formal classroom setting away from the work place. The training should concentrate on ensuring that the ACO develops a general understanding of all the standards, their applicability in different situations and the requirements for implementation. This can be accomplished mainly through the use of cases such as those presented in this research. The ACO is the key Government official responsible for the implementation of the Cost Accounting Standards, and without a good working knowledge of cost accounting and CAS, will not be able to properly carry out his/her duties.

Recommendation #2. Raise the thresholds for mandatory compliance with the Cost Accounting Standards. The current thresholds of $100,000 for a single contract or ten million dollars of total defense contracts in the preceding cost accounting period, were established over 20 years ago and are no longer realistic. Companies such as AEC that do predominantly commercial type business are now being required to comply with CAS. If the thresholds had been adjusted over the years to coincide more with the rate of inflation, many of these companies would be exempt from CAS coverage. It is these types of companies that are abandoning Government business because of the extreme administrative burdens placed on them by Government regulations such as the Cost Accounting Standards. The dollars that are saved or recouped from these companies because of adherence to the standards may not be worth the administrative effort that the Government and the contractor must go through to monitor and enforce them. This was evidenced by the cases examined here. In the future the Government will have less people to monitor requirements such as CAS, and must select those contractors where CAS can have the most benefit considering cost and reduced resources.

Recommendation #3. The implementation of a new Cost Accounting Standard should be on a prospective basis applicable to new contracts only. This will eliminate the

confusing and difficult-to-implement procedures that currently exist. Also, if applied properly, cost impact analysis will be unnecessary because all new contracts would be negotiated based on the new standard. The only drawback to this recommendation is that the contractor would have to maintain two accounting systems until the old contracts were completed. However, on the whole this would make the process of implementing a new standard much easier for the ACO and contractor to understand and execute, and eliminate costly and time consuming cost impact proposals and audits.

Recommendation #4. Change the focus of cost impact analysis from the current practice of looking only at what would have been negotiated throwing out the non-compliant practice and all of its associated costs, to an analysis which looks at two things:

1. Is there any evidence of fraud or gross misconduct that could be construed as fraud?

2. Are the costs incurred valid recoverable costs that were accounted for in a manner inconsistent with CAS?

If fraud is present then there is no question that the Government should prosecute and place full emphasis on cost recovery. However, in most cases the contractor is employing an accounting practice which is consistent with Generally

Accepted Accounting Principles (GAAP) and perfectly acceptable for commercial business.

If the DCAA auditor determines that the costs involved are valid but accounted for improperly then the actual cost impact to the Government will in all probability not be of a material concern. This will then allow the focus to be more on correcting the non-compliant practice rather than on cost impact and recovery. The Government must recognize that there are many gray areas in determining the exact impact of a CAS non-compliance. The quicker the accounting practice can be changed to conform to CAS the less impact it will have on future contracts and lessen the administrative burden of a prolonged dispute over the cost impact.

Recommendation #5. Encourage more communication and cooperation between DCAA and the contractor in order to more amicably settle CAS issues. DCAA and the contractor should work as a team to address the problem, develop solutions, and agree to an equitable method for determining any cost impact. The DCAA auditor should sit down with the contractor to develop a joint plan to resolve the non-compliant practice and provide an equitable cost impact analysis agreeable to both sides. This would eliminate trying to resolve these issues through the impersonal use of numerous letters, memos and audits as is the current practice. It would open up the lines

of communication and give each side a better understanding of the other's viewpoint. There is no doubt that by approaching the process in this manner that issues could be resolved much quicker and with a reduced administrative burden. It may also give industry a more favorable outlook on the Cost Accounting Standards.

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